HJ
5715
.E9
C2
c.3

Tax Legislative Counsel
Room 4028
Main Treasury Building

VALUE-ADDED TAX

European Experience and Lessons for the United States

George N. Carlson
Office of Tax Analysis
Department of the Treasury
October 1980

Tax Legislative Counsel
Room 4028
Main Treasury Building

TREAS
HJ
5715
.E9
C2
c.3

VALUE-ADDED TAX

European Experience and Lessons for the United States

George N. Carlson
Office of Tax Analysis
Department of the Treasury
October 1980

For sale by the Superintendent of Documents, U. S. Government Printing Office
Washington, D. C. 20402

PREFACE

This report examines the European Economic Community (EEC) experience with the value-added tax and draws lessons regarding U.S. adoption of a value-added tax. The report is a result of my participation in a Joint U.S.-EEC Fellowship Program sponsored by the Brookings Institution and the Commission of the European Communities, under a grant from the German Marshall Fund. The description and views expressed are not necessarily those of the European Community, Brookings Institution, or German Marshall Fund.

Many individuals and institutions contributed to this report. Special thanks are due to Emil M. Sunley of the Treasury Department, who encouraged me to undertake the study and to Leon J. Gordon of the Commission of the European Communities, who arranged my schedule of visits with European tax experts. Those individuals, too numerous to name, contributed immeasurably to the project by consenting to be interviewed and patiently answering my questions. Treasury Department colleagues Harvey Galper, Thomas O. Horst, and Mordecai S. Feinberg provided timely and helpful comments and suggestions. Finally, Carole Lee Garland deserves recognition for her extraordinary efforts in typing numerous preliminary and "final" drafts of the manuscript.

G. N. Carlson
October 1, 1980

Table of Contents

	Page
I. Issues and Scope	1
II. Description of Value-Added Tax	2
III. Reasons for Adoption	6
1. Formation of the European Economic Community	6
2. Neumark Committee	8
3. EEC Directives	10
(a) The First Directive	10
(b) The Second Directive	11
4. Capital formation	12
5. Tax reform	14
IV. Implementation	19
V. General Value-Added Tax System	27
1. Scope	28
2. Tax rates	30
3. Exemptions	34
4. Special schemes	37
(a) Small businesses	37
(b) Farmers	40
5. Specific Transactions	41
(a) Banking and finance	41
(b) Insurance	42
(c) Immovable property	43
(d) Nonprofit organizations	45
(e) Government provided goods and services	45
(f) Investment goods	45
VI. Administrative Aspects	48
1. Basic administrative mechanism	48
2. Invoice	50
3. Excess deductions	52
4. Cash flow	54
5. Multiple rates	55
6. Relation to income tax	56
7. Enforcement	58
8. Paperwork and personnel	61

Page

VII. Economic Effects 62

1. Direct-indirect tax structure 62
2. Capital goods 65
3. Price level 65
4. Foreign trade 69
5. Distribution of tax burden 70

VIII. Lessons and Analysis for the United States . 71

1. Motivation for adoption 71
2. Planning and publicity 72
3. Technical issues 72
4. Rates and exemptions 73
5. Retail sales tax alternative 74
   (a) Revenue collection and control of fraud 74
   (b) Enforcement 75
   (c) Business purchases 75
   (d) Number of taxpayers 77
6. Economic effects 77
   (a) Capital formation 78
   (b) Inflation 78
   (c) Balance of trade 79
   (d) Distribution of tax burden 80
   (e) Revenue potential 83
7. Federal-state relations 83

List of Charts and Tables

		Page
Chart 1	The Value-Added Tax Illustrated	3
Table 1	Example Demonstrating Equivalence of a Value-Added Tax and Retail Sales Tax . .	4
Table 2	Value-Added Taxes of European Economic Community Countries: History, Rates, Coverage, and Exemptions	31-33
Chart 2	United Kingdom Value-Added Tax Return . .	51
Chart 3	Illustration of a Value-Added Tax Invoice	53
Table 3	Taxes on Goods and Services as a Percentage of Total Taxes and Value-Added Taxes as a Percentage of Total Taxes, 1967-1977	64
Table 4	Federal, State, and Local Tax Revenues for Selected Countries as a Percent of Gross Domestic Product, by Type of Tax, 1977	81

I. ISSUES AND SCOPE

Periodically over the past decade the Federal government has considered the value-added tax. In the early 1970s, the President's Task Force on Business Taxation, the Treasury Department, the Advisory Commission on Intergovernmental Relations, and the Congressional Joint Economic Committee all assessed its merits. More recently, Congressman Ullman, Chairman of the House Committee on Ways and Means, proposed a value-added tax as a major element in H.R. 7015, the "Tax Restructuring Act of 1980." 1/

Much of this interest has undoubtedly been stimulated by widespread acceptance of the value-added tax in Europe. All members of the European Economic Community (EEC), Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, the Netherlands and the United Kingdom have adopted the value-added tax. Outside the EEC, Austria, Norway, and Sweden rely on the value-added tax.

This report examines the EEC experience with the value-added tax and draws lessons regarding U.S. adoption of a value-added tax. It explains why the EEC countries chose the value-added tax and the steps they found necessary to familiarize both taxpayers and revenue service personnel with it. The report describes the EEC value-added tax systems, with emphasis on their scope, rates, coverage, and special provisions and problems. Since some critics of the value-added tax believe that it would greatly complicate the U.S. tax system, the report describes EEC administrative procedures. The report also reviews the economic impact of the value-added tax in the EEC.

Although the report neither proposes nor rejects a value-added tax for the United States, it observes that it was adopted in Europe for unique reasons not applicable to the United States. While substantial effort was required to successfully implement the tax in Europe, even more may be necessary in the United States. The debate over a Federal consumption tax should not exclude consideration of a retail sales tax. It would allow the United States to benefit from experience at the state level and would have the same economic impact as a value-added tax.

1/ This proposal was recently withdrawn. See Tax Notes, August 25, 1980, p. 392.

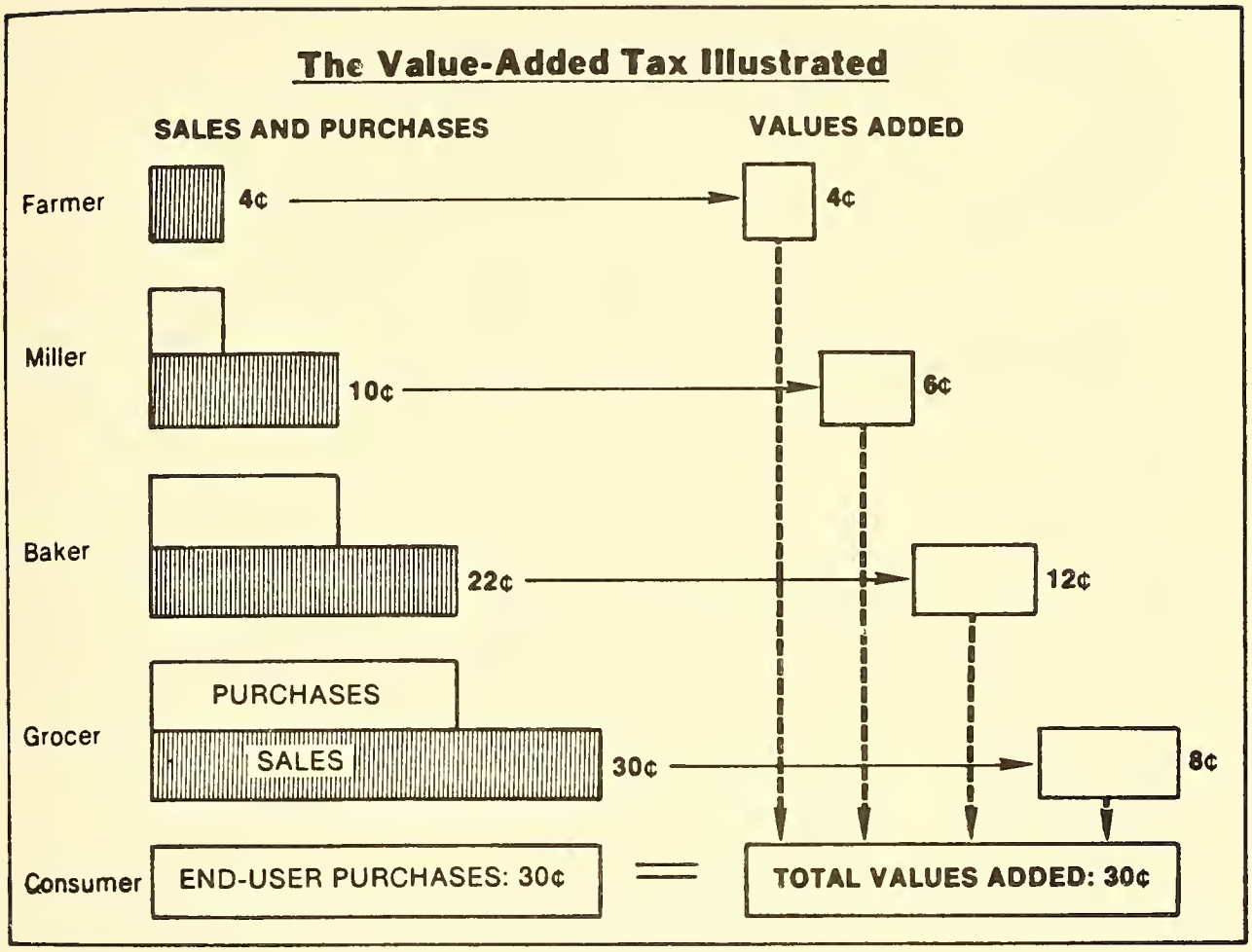
II. DESCRIPTION OF VALUE-ADDED TAX

A value-added tax is a multistage sales tax on consumer goods and services. It is similar to a retail sales tax in that consumers ultimately bear the burden of the tax, but it differs in that it is collected piecemeal throughout the production and distribution process, not just at the retail stage. In a normal business operation, a firm purchases raw materials from its suppliers and produces a product by processing, manufacturing, and otherwise "adding value" to those purchases. A value-added tax is levied on the amount of value added (the difference between sales and purchases) at each stage in the production and distribution process. Since the retail price of a product is equal to the total of the values added, as shown in Chart 1, a value-added tax is the economic equivalent of a tax on the retail value of a product.

While tax liability may be calculated in a number of ways, all European value-added tax countries use the "invoice" or "credit" method. A firm calculates tax on its sales, subtracts tax imposed on purchases, including capital equipment, and pays the difference to the government. Any excess of tax imposed on purchases over tax due on sales is either refunded or carried forward as an offset against future tax liability. The capital equipment tax deduction eliminates the burden of the tax on capital goods. Since only consumption goods bear the tax, the incidence is on consumers.

A value-added tax is similar to a retail sales tax in that the total tax is equal to the retail price of the product multiplied by the tax rate. The example in Table 1 of a consumer's purchase of an electronic calculator illustrates that an equal rate value-added tax generates the same tax revenue as a retail sales tax. Each tax is levied at 10 percent. Before any tax is imposed, the calculator sells for $100. If a retail sales tax of 10 percent is charged, the government receives $10.00 in revenue and the consumer pays $110 for the calculator. The same result occurs with a value-added tax. The government collects $10.00 in revenue and the consumer pays $110 for the calculator, but the tax is collected at four stages: $2.00 each at the mining, manufacturing, and wholesale stages and $4.00 at the retail stage.

Chart 1



Source: Advisory Commission on Intergovernmental Relations, The Value-Added Tax and Alternative Sources of Federal Revenue, 1973, p. 19.

Table 1

Example Demonstrating Equivalence of a Value-Added Tax and Retail Sales Tax
Product is a Calculator Sold for $100 Before Tax

Product Cycle Stage	Value Added Tax (10 percent)			Retail Sales Tax (10 percent)		
	Before Tax	Tax	After Tax	Before Tax	Tax	After Tax
Mining						
Sales	20	2	22	20	0	20
Purchases 1/	0	0	0	0	0	0
Tax to Government		2			0	
Manufacturing						
Sales	40	4	44	40	0	40
Purchases	20	2	22	20	0	20
Tax to Government		2			0	
Wholesale						
Sales	60	6	66	60	0	60
Purchases	40	4	44	40	0	40
Tax to Government		2			0	
Retail						
Sales	100	10	110	100	10	110
Purchases	60	6	66	60	0	60
Tax to Government		4				
Final, After Tax Retail Price of Calculator			110			110
Total Tax Collected		10			10	

1/ The assumption of zero purchases at the first stage does not affect the result. The assumption is made solely to simplify the example.

The only difference is that revenue is collected at one stage under the retail sales tax and at several stages under the value-added tax. This is a cosmetic, not a substantive, economic difference. The deduction for value-added tax on purchases assures that the full value of the product is taxed only once. There is no multiple or cascade taxation of the product.

The deduction for tax paid on purchases also means that the tax burden is confined to consumers. No tax is borne by business purchases. The tax which producers pay on their purchases is deductible from the tax which they charge on their sales. Their business customers, in turn, are also allowed to deduct the taxes imposed on their purchases. Only final consumers are not allowed to deduct tax paid on purchases. As with a retail sales tax, consumers pay the value-added tax. If the calculator was purchased by a business, rather than a final consumer, the business purchaser would be entitled to deduct the tax paid on the purchase. Under a retail sales tax, the business purchaser would need to present an exemption certificate to be able to buy tax free.

An important implication of this "tax and deduction" system is that the tax on a product is determined solely by the tax imposed at the retail stage. In effect, pre-retail taxes do not matter. In the above example, suppose that the mining, manufacturing, and wholesale stages were each subject to a 10 percent value-added tax, but the retail stage to only a 5 percent tax. The situation would then appear as follows at the retail stage:

Product Cycle Stage	Before Tax	Tax	After Tax
Retail			
Sales	100	5	105
Purchases	60	6	66
Refund to Retailer		-1	

The tax generates $5 in revenue and the consumer pays $105 for the calculator. The retailer actually receives a refund of $1, the difference between the $5 tax due on sales and $6 tax imposed on purchases. Although pre-retail stages are taxed at 10 percent, the actual tax on the final product is only 5 percent.

III. REASONS FOR ADOPTION

The value-added tax is not new. Wilhelm von Siemens is credited with first proposing the tax for Germany in 1919. 1/ Thomas S. Adams suggested it as a substitute for the U.S. corporate income tax in 1921. 2/ As part of its 1949 study, the Shoup Taxation Mission advocated a value-added tax for Japan based on the sum of wages, interest, rental payments, and profits. 3/ Although enacted by Japan's Diet, the tax was never put into effect because it was opposed by labor as regressive and by business as an unfair burden on labor-intensive firms. 4/ Little progress was made in popular acceptance of a value-added tax until France completed the replacement of its production tax with a wholesale level value-added tax in 1955. 5/ The real growth in the acceptance of the value-added tax, however, stems from the formation of the European Economic Community (EEC) and the Community's interest in tax harmonization. This development was followed by the adoption of the value-added tax by Denmark (1967), France 6/ and Germany (1968), the Netherlands (1969), Luxembourg (1970), Belgium (1971), Ireland (1972), and Italy and the United Kingdom (1973).

1. Formation of the European Economic Community. The European Economic Community, or Common Market, was established by the Treaty of Rome on March 25, 1957. 7/

1/ John F. Due, Sales Taxation, University of Illinois Press, Urbana, 1957, p. 138.

2/ Thomas S. Adams, "Fundamental Problems of Federal Income Taxation," Quarterly Journal of Economics, Vol. 35, No. 4, 1921, p. 553.

3/ Due, op. cit., pp. 141-142.

4/ Ibid., pp. 142-143.

5/ Ibid., pp. 119-125.

6/ France extended its wholesale level value-added tax to the retail stage in 1968.

7/ European Economic Community, European Community Facts, Washington, D.C., 1979, p. 6.

Belgium, the Federal Republic of Germany, France, Italy, Luxembourg, and the Netherlands were the original members. 1/ The membership grew to nine countries on January 1, 1973 when Denmark, Ireland, and the United Kingdom joined. 2/ A major objective of the Treaty creating the Community was "the establishment of a common market by way of...the free movement of persons, goods, services and capital." 3/

The framers of the Treaty clearly recognized that the elimination of tariff barriers would not be sufficient to create a common internal market if the tax systems of the Member States were allowed to function as trade barriers instead. Accordingly, the taxation provisions of the Treaty of Rome are aimed at guaranteeing the free movement of goods and services. Article 95, for example, provides that a Member State may not impose taxes on the products of other Member States that are greater than those which it imposes on its own products. 4/ According to Article 96, the repayment of taxes on goods exported to another Member State may not exceed the domestic taxes actually imposed on the exports. 5/ Articles 95 and 96 thus implement the destination principle of border tax adjustment for taxes on products; by means of a compensatory tax on imports and a rebate of tax on exports, goods are taxed where they are consumed, rather than where they are produced. Articles 95 and 96 of the Treaty of Rome also comport with the provisions of the General Agreement on Tariffs and Trade which permit destination principle border tax adjustments for indirect taxes, such as a value-added tax, but not for direct taxes, such as the corporate income tax. 6/

1/ Ibid., p. 3.

2/ Ibid., p. 3.

3/ Commission of the European Communities, Report from the Commission to the Council on the Scope for Convergence of Tax Systems in the Community, Brussels, 1980, p. 3.

4/ Commerce Clearing House, "Treaty Establishing the European Economic Community," Common Market Reporter, Vol. 1, p. 2211.

5/ Ibid., p. 2218.

6/ General Agreement on Tariffs and Trade, Articles III and XVI. The Agreement is reprinted in Kenneth W. Dam, The GATT, Law and International Economic Organization, 1970, pp. 391-468.

When the Treaty of Rome was signed in 1957, all Member States, except France, imposed a cascade turnover tax. 1/ A tax was levied on each sale of an item as it passed through the various stages in the production process. Because no relief was given for prior-stage taxes, the ultimate tax liability on a product depended on the number of sales between the initial processing of the raw materials and the final sale of the finished product. Since the precise amount of cascade tax on a particular product was indeterminate, Member States did not know how much tax could be imposed on imports or rebated on exports, as provided by Articles 95 and 96. Consequently, Article 97 of the Treaty contains a transitional measure allowing Member States to use average import taxes and export rebates, provided there is no infringement of Articles 95 and 96. 2/ These average border tax adjustments were only an approximation; in some cases they overcompensated exports and overtaxed imports, while in other cases they did the opposite. This was an untenable situation in a common market seeking to achieve the free, unrestricted movement of goods and services. Therefore, Article 99 3/ of the Treaty of Rome instructed the EEC Commission 4/ to consider how the various turnover taxes of the Member States could be harmonized.

2. Neumark Committee. The Commission responded to this instruction in 1960 by appointing the Fiscal and Financial Committee to study the extent to which the tax systems of the Member States conflicted with the establishment of a

---

1/ David V. G. dePass, "Value Added Tax: The Concept and Current Progress Towards Harmonization in the European Economic Community," California Western International Law Journal, Vol. 9, 1979, p. 4.

2/ Commerce Clearing House, "Treaty Establishing the European Economic Community," op. cit., p. 2219.

3/ Ibid., p. 2228.

4/ The Commission is responsible for proposing Community policy. The thirteen members, two each from France, Germany, Italy, and the United Kingdom, and one each from the remaining five States are obligated to act independently of their national governments and in the Community's interest.

common internal market. The Committee, chaired by Professor Fritz Neumark of Germany, rapidly recognized the defects of the gross or cascade turnover tax.

> It causes distortions of competition within the national economies where it is applied and artificially promotes the concentration of enterprises, but, in addition, it distorts the international trade relations because of the impossibility of calculating exactly the overall charge of the turnover tax burden on a specific commodity and consequently -- when the principle of country of destination is applied -- the amount of the corresponding countervailing levies or refunds. 1/

Consequently, the Neumark Committee recommended that the Member States abolish the cascade tax and adopt the value-added tax in its place. 2/ The fact that France already had a value-added tax, and that it was being contemplated by Germany, obviously influenced the Committee's deliberations. "Such a tax exists at the present only in one of the Member States, namely, in France, but for some time other countries, Germany in particular, have had forces at work which aim at a tax reform adopting the tax on net turnover." 3/

The Neumark Committee did not believe that a retail sales tax was a suitable alternative to a value-added tax. "It will not be feasible to impose as the sole form of the turnover tax a single tax at the retail stage, due to the practical reasons of fiscal technicalities (particularly considering the very large number of small retail merchants, most of whom are unable to keep exact books)." 4/ In fact, the Neumark Committee considered the problems in applying

---

1/ Neumark Committee, Tax Harmonization in the Common Market, Report of the Fiscal and Financial Committee on Tax Harmonization in the Common Market, Commerce Clearing House, 1963, p. 46.

2/ Ibid., p. 49.

3/ Ibid., p. 47.

4/ Ibid., p. 47.

even the value-added tax to the retail stage so intractable, that it recommended the exclusion of the retail stage from the value-added tax. 1/

3. EEC Directives. The EEC Commission agreed with the findings of the Neumark Report and recommended the elimination of the cascade turnover tax and the adoption of a wholesale-stage value-added tax within the EEC. 2/ This recommendation, which was made to the Council of Ministers 3/ in 1962, was eventually adopted as part of the EEC Council's First and Second Directives on the harmonization of turnover taxes. 4/ Both directives were issued April 11, 1967.

(a) The First Directive. This required Member States to replace their turnover taxes with a value-added tax by January 1, 1970. 5/ Belgium and Italy were unable to comply with the original deadline and were granted an extension. Ireland and the United Kingdom were not bound by the original deadline because they were not EEC members in 1970. The Directive provided that value-added tax liability was to be calculated under the "invoice" or "credit" method, with tax imposed on purchases being deducted from tax due on sales. 6/ The deduction for tax imposed on purchases prevents the multiple taxation which was an objectionable feature of the cascade turnover taxes. Unlike the recommendation of both the Neumark Committee and the EEC Commission, the value-added tax mandated by the First Directive applied to the retail

---

1/ Ibid., p. 49.

2/ Ibid., pp. 98-100.

3/ The Council of Ministers makes major Community Policy decisions. It has nine members, one representative from each Member State. The Ministers attending Council Meetings vary depending on the subject under consideration, taxation, agriculture, trade, etc.

4/ "First Council Directive" and "Second Council Directive," reprinted in Commerce Clearing House, Common Market Reporter, Vol. 1, pp. 2357.5-2369.

5/ "First Council Directive," op. cit., Article 1.

6/ Ibid., Article 2.

stage. 1/ A Member State was given the option, however, of applying it only through the wholesale stage, provided it levied a supplementary retail tax. 2/

(b) The Second Directive. In contrast to the First Directive, which merely required Member States to adopt a value-added tax, the Second Directive provided some detail regarding the type and structure of value-added tax. Value-added tax was imposed on the delivery of goods and services within the country and on the import of goods. 3/ Exports were fully exempt from value-added tax. 4/ Thus, the Second Directive permitted the destination principle of border tax adjustment.

The Second Directive defined the terms "taxable event," 5/ "tax base," 6/ "taxpayer," 7/ "delivery of goods," 8/ "place of delivery," 9/ "service," 10/ and "import of goods." 11/ The taxation of services was compulsory only for services associated with the sale of goods, such as the transfer of patents, advertising, and the

---

1/ Ibid., Article 2.

2/ Ibid., Article 2.

3/ "Second Council Directive," op. cit., Article 2.

4/ Ibid., Article 10, paragraph 1(a).

5/ Ibid., Article 5, paragraph 5.

6/ Ibid., Article 8.

7/ Ibid., Article 4.

8/ Ibid., Article 5, paragraphs 1-3.

9/ Ibid., Article 5, paragraph 4.

10/ Ibid., Article 6, paragraph 1.

11/ Ibid., Article 7, paragraph 1.

transportation of goods. The taxation of services purchased by consumers, such as for legal, dental, or medical, purposes, was not compulsory. 1/

The Second Directive also provided for a consumption-type value-added tax. A taxpayer was allowed an immediate deduction for tax paid on purchases of capital equipment. 2/ This deduction eliminated the value-added tax on capital goods.

The Second Directive did not specify particular value-added tax rates. Each Member State was allowed to set its own normal rate, as well as increased or reduced rates. 3/ Where application of the normal system of value-added taxation to small enterprises or agricultural activities would "encounter difficulties," a Member State could apply "the special rules best suited to national requirements and possibilities." 4/

The Directive recognized that business firms might defer capital goods acquisitions until the effective date of the value-added tax to qualify for the purchase tax deduction not available under the cascade tax. As a transitional measure, it permitted Member States either to allow a deduction for part of the cascade tax paid on capital purchases against the value-added tax or to restrict the deduction normally allowed under the value-added tax for tax paid on the purchase of capital equipment. 5/

4. Capital formation. While the formation of the EEC, the Neumark Report, and the First and Second Directives on tax harmonization provided a very strong impetus to the adoption of the value-added tax, these were not the only reasons.

France, for example, adopted a wholesale-stage value-added tax in 1954-1955, before the formation of the EEC or the issuance of the Directives, in culmination of a gradual

---

1/ Ibid., Article 6, paragraph 2 and Annex B.

2/ Ibid., Article 11.

3/ Ibid., Article 9.

4/ Ibid., Articles 14 and 15.

5/ Ibid., Article 17.

reform of its indirect taxation system. 1/ France levied a cascade turnover tax from 1920 to 1936 when it was replaced by the production tax, a single stage manufacturers sales tax on finished products, both consumer and capital goods. 2/ The production tax was converted to a multi-stage tax in 1948 "to give a temporary boost of revenue to the French Treasury in the financial crisis of 1948, by making French industry liable to pay the production tax at earlier stages of production than the stage at which it had previously been payable." 3/ The production tax avoided the multiple taxation problem inherent in a cascade tax by allowing producers to deduct tax charged by their suppliers on materials, parts, semi-finished goods, and items consumed in the production process. 4/ This deduction was similar to the invoice or deduction method of calculating value-added tax liability eventually adopted by the EEC.

The evolution to a consumption-type value-added tax occurred in France between 1953 and 1955 when the right of a producer to deduct tax imposed on purchases was extended to investment goods. 5/ This was done to reduce the tax burden on capital and thereby encourage investment.

> In the period before 1954 the French authorities had become concerned with the effect of the existing production tax on productivity. They saw that, whereas the United States and the United Kingdom had taxes which fell only on consumption goods, European countries were taxing both investment and consumption goods. They recognized that a tax on investment goods was a handicap to productivity.... The basic aim of the reforms of 1953-

---

1/ Due, op. cit., pp. 124-125.

2/ Ibid., pp. 115-120.

3/ Gordon Richardson, Chairman, Report of the Committee on Turnover Taxes, Her Majesty's Stationery Office, 1964, paragraph 25.

4/ Due, op. cit., p. 119.

5/ Richardson, op. cit., paragraph 26.

1955 was simply to transform a tax, which had previously fallen on investment and consumption goods alike, into a tax falling only on consumption goods. 1/

The investment incentive issue also was prominent in Belgium, Germany, Italy, and the Netherlands, where the value-added tax replaced cascade turnover taxes. Capital goods, of course, had been subject to cascade tax, but would be free of tax in the value-added tax system. In Belgium, Germany, and the Netherlands, however, the investment incentive was blunted by a transitional measure which limited the deduction for tax imposed on purchases of capital equipment. Fiscal authorities were fearful that allowing taxpayers a full and immediate deduction for taxes paid on capital goods would encourage them to postpone their investment purchases until the value-added tax was adopted. The alternative of allowing a deduction for cascade tax on capital equipment would have deprived the treasuries of these countries of large amounts of revenue.

5. Tax reform. Ireland introduced a value-added tax on November 1, 1972 and the United Kingdom on April 1, 1973, each as a condition of joining the EEC on January 1, 1973. 2/ Although neither imposed a cascade turnover tax, each country had become dissatisfied with its previous system of taxation. Ireland, for example, was concerned about abuse of the privilege under its retail sales tax to make tax free purchases for business use. This was necessary to avoid the multiple taxation characteristic of a cascade turnover tax. An individual purchasing items for business use, such as office and stationery supplies, would qualify for the tax exempt privilege by quoting a registration number to the seller. It was difficult, however, for the seller to know if the purchase was for business, rather than personal, use. 3/ Irish authorities turned to the value-added tax because a seller would no longer be required to make this distinction. All sales would be taxable, but the

---

1/ Ibid., paragraph 93.

2/ Price Waterhouse, Value Added Tax, New York, 1979, pp. 45 and 79.

3/ Discussion with officials of the Office of Revenue Commissioners, Value-Added Tax Branch, Dublin, March 10-11, 1980.

purchaser would only be allowed to deduct tax imposed on purchases for business use. According to the Irish revenue authorities, the value-added tax is superior to the retail sales tax in controlling the business purchases problem because it is easier to check the firm claiming the deduction than its supplier. 1/

The United Kingdom considered the value-added tax on several occasions before its adoption in April 1973. In 1964, the Committee on Turnover Taxes, also known as the Richardson Committee, studied the value-added tax as a replacement for either the purchase or corporate profits tax. The purchase tax was a single-stage tax imposed at the wholesale level on consumer goods. The Richardson Committee was appointed by the government in response to a concern that European tax systems were more conducive to economic growth and export performance than was the United Kingdom's. 2/ The Committee noted that both the purchase tax and the value-added tax were taxes on consumer expenditures and that the United Kingdom did not share the European experience and familiarity with multi-stage sales taxes. Accordingly, it expressed strong reservations over changing to a more complex system of taxation.

> The purchase tax system in fact affords a more logical, efficient and economical means of consumer taxation than a value-added tax.... There is no logic in the change from an established single-stage system to a multi-stage system spread over the successive stages of production and distribution and applying not only to the finished consumer product but to all its constituents at earlier stages when the object of the tax is the final consumer product. The situation was different in France where the value-added tax was evolved from a tax which was already widely spread over successive stages and which already applied not

---

1/ Discussion with officials of the Office of Revenue Commissioners, Value-Added Tax Branch, Dublin, March 10-11, 1980.

2/ Richardson, op. cit., paragraph 1.

> only to the finished product but to its constituents. This is also the case in other Continental countries which are considering moving to a value-added system. 1/

Not surprisingly, the Richardson Committee opposed substituting a value-added tax for either the purchase tax or the tax on corporate profits. 2/

A few years later, as part of a study of taxation and economic growth, a committee of the National Economic Development Office (NEDO), a U.K. government agency with business, union, and government representation, reached a more sympathetic view of the value-added tax. The NEDO report, published in 1969, acknowledged that a value-added tax would raise significant amounts of revenue, but cautioned that it would create substantial administrative problems and costs. 3/ These costs might be justified, it noted, by the efficiency and trade gains associated with a large corporate tax reduction made possible by a value-added tax. 4/ With regard to a change in the method of indirect taxation, the report observed that a value-added tax might be superior to the purchase tax in freeing producers' goods of tax, thereby facilitating trade and production neutrality. 5/

One year after the publication of the NEDO report, the Conservative Party, in the General Election of 1970, pledged to seek U.K. membership in the EEC and to reform the country's tax system. The party's election manifesto promised to "... abolish the selective employment tax, as part of a wider reform of indirect taxation, possibly involving replacement of the purchase tax by a value added tax." 6/

1/ Ibid., paragraph 303.

2/ Ibid., paragraph 323.

3/ National Economic Development Office, Value Added Tax, London, Her Majesty's Stationery Office, 1969, p. 4.

4/ Ibid., p. 5.

5/ Ibid., pp. 63-64.

6/ Dorothy Johnstone, A Tax Shall Be Charged, London, Her Majesty's Stationery Office, 1975, p. 12.

Since services were not subject to purchase tax, the selective employment tax had been introduced in 1966 as a levy on employee services, but payable by the employer. A number of defects in the tax soon became evident.

> The tax mechanism was so cumbersome and ill-applied that it has caused economic distortions in trade. In addition, there were no relief provisions for services related to exports, many services were not covered at all, and there also was a large increase in "moonlighting" activities especially in the construction industry. 1/

After winning the election, the Conservative government announced in a March 1971 "Green Paper" its intention to eliminate the selective employment tax.

> The Government is committed to undertake, during the life of this Parliament, a major reform of the taxation system that will include the abolition of the selective employment tax and a radical simplification of a tax system that has been allowed to become too complex and discriminatory. 2/

Although indirect taxes were relatively high in the United Kingdom, 3/ they were derived from a relatively narrow base of consumer expenditures; excises on alcohol, fuel, and tobacco and the purchase tax on consumer durables. 4/ The new government sought a more broadly-based system of indirect taxation which, "by discriminating less between different types of goods and services, would reduce the distortion of consumer choice." 5/

1/ "United Kingdom: Value Added Tax," European Taxation, October, 1972, p. 256.

2/ Value-Added Tax, Green Paper, Presented to Parliament by the Chancellor of the Exchequer by Command of Her Majesty, London, Her Majesty's Stationery Office, 1971, p. 3.

3/ National Economic Development Office, op. cit., pp. 22-23.

4/ Ibid., p. 2.

5/ Value-Added Tax, Green Paper, op. cit., p. 3.

The value-added tax was a logical choice. The purchase tax could not be extended to services because it was levied at the wholesale stage. 1/ A cascade turnover tax was rejected because it would distort the industrial structure, penalize capital formation, and complicate the calculation of border tax adjustments. 2/ A retail sales tax was characterized as "impracticable" because all the revenue would be collected at the retail stage. 3/ With an eye on the EEC Directives, the Green Paper opted for a value-added tax because it would improve efficiency and "an increasing number of countries are adopting the value-added tax." 4/ Accordingly, on March 30, 1971, Anthony Barber, the Chancellor of the Exchequer, announced in his budget speech that a value-added tax would be introduced, to be effective April 1973. 5/

1/ Ibid., p. 4.

2/ Ibid., p. 4.

3/ Ibid., p. 4.

4/ Ibid., p. 4.

5/ Johnstone, op. cit., p. 126.

IV. IMPLEMENTATION

In nearly all EEC countries, the switch to the value-added tax meant additional taxpayers and more detailed accounting and reporting requirements. The cascade turnover taxes of Belgium, 1/ and the Netherlands, 2/ for example, as well as the pre-1968 French value-added tax, 3/ did not apply to retailers. The single-stage sales taxes of Denmark, Ireland, and the United Kingdom excluded many taxpayers covered by a value-added tax. In Germany, there was very little increase in the number of taxpayers because the cascade tax was relatively comprehensive, applying even to retailers and to services. 4/ The number of taxpayers increased from 28,000 to 35,000 in Ireland, 5/ from 250,000 to 300,000 in the Netherlands, 6/ and from 75,000 7/ to about 1.25 million in the United Kingdom. 8/

The cascade turnover and single-stage taxes shared the common characteristic that tax liability was determined exclusively on the basis of sales or turnover. The Belgian and Italian turnover taxes did not even require the taxpayer to file a return. Revenue stamps were purchased from banks, post offices, and other outlets and attached to the invoice documenting a sale. 9/ The value-added tax, in contrast,

---

1/ Due, op. cit., p. 94.

2/ Ibid., p. 86.

3/ Ibid., p. 125.

4/ Ibid., p. 53.

5/ Discussion with officials of the Irish Office of Revenue Commissioners, Value-Added Tax Branch, Dublin, March 10-11, 1980.

6/ Discussion with officials of the Netherlands Ministry of Finance, The Hague, March 12, 1980.

7/ Johnstone, op. cit., p. 7.

8/ Commissioners of Her Majesty's Customs and Excise, Review of Value Added Tax, London, Her Majesty's Stationery Office, 1978, p. 8.

9/ Due, op. cit., p. 96.

requires a taxpayer to report his purchases as well as his sales. The result is more detailed record keeping and accounting for taxpayers and additional enforcement and audit responsibilities for revenue authorities. Dorothy Johnstone, who was closely involved with the planning and introduction of the U.K. value-added tax as Under Secretary (Machinery) in the Value-Added Tax Division of the Customs and Excise Department, commented on the magnitude of the problem for the United Kingdom.

> For VAT, a register of over a million names had to be set up; thousands of millions of transactions had to be, in principle at least, singly recorded and accounted for; a vast volume of new administrative paper had to be organized to flow between taxpayers and the tax authority. 1/

Considering the additional taxpayers and accounting demands, it is not surprising that the introduction of the value-added tax was accompanied by elaborate information and education programs designed to explain the new tax to unfamiliar businesses and consumers.

Starting in April 1969, two years before the tax became effective, Belgium inaugurated an information program aimed at both taxpayers and consumers. The program, which described the operation and effect of the new tax, relied heavily on newspaper and television advertising and the dissemination of information by trade associations. 2/ Special attention was devoted to the expected price impact of the value-added tax. In an effort to hold the prices of goods constant, the new law provided that cascade turnover tax paid on inventories was deductible against a taxpayer's value-added tax liability. 3/ The Belgian government opened special telephone numbers which traders and consumers could call for an explanation of the expected price impact of the tax.

1/ Johnstone, op. cit., p. 7.

2/ Discussion with officials of the Belgian Ministry of Finance, Brussels, March 17, 1980.

3/ International Bureau of Fiscal Documentation, Value-Added Taxation in Europe, Amsterdam, current loose-leaf service, Belgium, section 9.3.

Six months of Parliamentary hearings with trade and industry groups preceded the enactment of the German value-added tax law in May, 1967. This was followed by a seven-month information program lasting until the tax took effect on January 1, 1968. The publication of a handbook describing the new system and the use of mock invoices and tax returns were important elements in the program. The "trial run" invoices and returns provided taxpayers with experience in compiling a correct return and alerted the revenue authorities to unexpected problems. 1/

In contrast to Germany's relatively brief transition, Ireland prepared for the value-added tax over a two and one-half year period. Although the law was enacted July 1, 1972 and took effect November 1, 1972, the decision to introduce a value-added tax was made in July 1970. 2/ This decision was followed by the March 1971 publication of a paper, "Proposals for a Value-Added Tax", and by the October 1971 publication of draft legislation. The "Proposals" paper described the tax and invited comment from interested parties. 3/

Officials from the Irish Office of Revenue Commissioners attended public meetings throughout the country to explain the new tax. Seminars, including slide shows demonstrating how to complete a value-added tax return, were held with chambers of commerce, associations of manufacturers, wholesalers, retailers, and other representative bodies. A "Guide to the Value-Added Tax" was issued in July 1972. It was representative of a wide variety of published material designed to familiarize the business community with the new tax. 4/

1/ Discussion with officials of the German Ministry of Finance, Bonn, March 20, 1980.

2/ Office of Revenue Commissioners, Value-Added Tax Branch, "Value-Added Tax," Dublin, unpublished paper, p. 1.

3/ Ibid., p. 4.

4/ Ibid., p. 5.

The Irish Minister of Finance also appointed an Advisory Council "to consider any transitional problems arising from the implementation of the Value-Added Tax Act." 1/ The Council, whose six-months tenure spanned the three months before and after the introduction of the tax, was composed of representatives from industry, trade, commerce, agriculture, and consumers. A senior official of the Value-Added Tax Branch of the Office of Revenue Commissioners attended the Council meetings in an advisory capacity. 2/

The Advisory Council offered suggestions to the Minister of Finance in the four areas in which it concentrated its efforts: (1) farmers and new taxpayers; (2) transitional problems facing taxpayers formerly subject to wholesale and retail sales tax; (3) technical issues; and (4) the impact of the value-added tax on the cost of living. To minimize the price impact of the new tax the Council "engaged in a publicity campaign and extensive advertisements were put in the national dailies and space was booked on radio and television, indicating the areas where prices would...be affected by the tax." 3/ Business representatives stress that the Irish government's extensive education campaign, both before and after the introduction of the value-added tax, facilitated acceptance of the tax by the business community. 4/

Like Ireland, the Netherlands provided business and commercial organizations with an advance draft of its proposed value-added tax legislation. "This enabled entrepreneurs to get to know the new system and enabled the drafters of the bill to take their views into account." 5/ In the six

---

1/ Advisory Council on the Transition to Value-Added Tax, Final Report of the Council to the Minister for Finance, Dublin, 1973, p. 1.

2/ Ibid., p. 1.

3/ Ibid., p. 2.

4/ Discussion with representatives of the Dublin Chamber of Commerce, Dublin, March 11, 1980.

5/ K. Millenaar, Director of Taxes, Head of the Customs Duty and Consumption Tax Directorate, Netherlands Ministry of Finance, The Hague, "Value-Added Tax in the Netherlands," an address to the Finance Committee of the Israeli Parliament, 1972, p. 13.

months between the passage of the value-added tax law and its effective date, the government relied on lectures, booklets, personal visits, television courses, and special telephone numbers to disseminate information about the new tax. 1/ Much of this information was aimed at small taxpayers since it was assumed that the large established traders would have access to expert accounting and legal advice. 2/

Soon after the June 1970 election of the Conservative government in the United Kingdom, the Customs and Excise Department began its work on the value-added tax. The first few weeks were spent assembling a value-added tax planning unit. This was followed by the drafting of a "Green Paper" describing the tax and a series of papers on potential special treatment areas, such as food, farmers, and buildings. 3/ By early 1971 Customs and Excise held its first meetings with industry and trade associations. 4/

In order to benefit from European experience, Customs and Excise officials "composed small delegations to visit other countries where VAT already existed and talk to the civil servants who were running it in those countries." 5/ All this was done before the government's formal value-added tax announcement on March 30, 1971. 6/ Along with the announcement the government issued its Green Paper describing the tax and inviting "trade and professional associations and other interested parties an opportunity to consider and comment on those aspects of the tax that would particularly affect them." 7/

1/ Ibid., pp. 13-14.

2/ Ibid., p. 13.

3/ Johnstone, op. cit., pp. 14-20.

4/ Ibid., p. 20.

5/ Ibid., p. 21.

6/ Ibid., p. 21.

7/ Value-Added Tax, Green Paper, op. cit., p. 3.

By autumn of 1971, Customs and Excise was having daily consultations and meetings with trade associations. A dozen discussion papers on registration, valuation, partial exemption, and other important issues were circulated to 400 trade and professional bodies. 1/ The papers and consultations created an important two-way flow of information. The business community not only learned the government's thinking, but was given an opportunity to respond to specific proposals.

> [A]ll the responses we received were read, tabulated and thought about, and as there were thousands of them altogether, that in itself was a substantial task. But we found it a very valuable source of ideas and enlightment. 2/

The consultation with traders continued throughout the 1972-1973 period, even extending past the April 1, 1973 introduction of the tax.

> We let it be known that we would be ready and anxious to provide speakers on VAT for gatherings of prospective taxpayers arranged by trade associations, chambers of commerce, industrial training boards, professional institutes and similar bodies. By the middle of 1973, to our considerable astonishment, we added up the results and found that we had addressed over 11,000 of such gatherings. 3/

Both government officials and business representatives agreed on the importance of these consultations.

> As for the consultative meetings themselves, I should say straight away that the amounts of education, advice and assistance that we received from the representative bodies were immense, and while

---

1/ Johnstone, op. cit., pp. 28-29.

2/ Ibid., p. 29.

3/ Ibid., p. 83.

> we hoped that the meetings were useful to the prospective taxpayers, we were in no doubt whatever about their usefulness, in total, to us as tax administrators. 1/

Business representatives, in turn, believe that the consultations enabled them to explain standard, but unfamiliar, business practices to revenue officials. This allowed for a tax that conformed to these practices, rather than one that forced unusual business practices on industry. 2/

The consultations were supplemented by published materials and advertisements. Two notices, a General Guide, and a Scope and Coverage statement, were published in the fall of 1972, after the passage of the law.

> The two main notices, together with the registration form, the supplementary registration forms for certain types of businesses, the list of trade classifications into which businesses were asked to categorize themselves, an envelope for posting the forms, a reply-paid postcard for sending other notices, and a friendly introductory letter from the Chairman of the Board of Customs and Excise, were assembled into what we called officially the general information package. 3/

This material was mailed to businesses subject to value-added tax and its availability was made known through posters in banks, post offices, and other public places and through advertisements in trade journals. 4/

Concurrent with the consultation and information program, the United Kingdom faced the need to hire and train additional staff. About 75,000 businesses had been registered for purchase tax; the value-added tax would involve

---

1/ Ibid., p. 30.

2/ Discussion with representatives of the U.K. Oil Industry Taxation Committee, London, April 11, 1980.

3/ Johnstone, op. cit., p. 89.

4/ Ibid., p. 90.

over one million taxpayers and require a staff of at least 8,000 individuals, 6,000 more than that assigned to the purchase tax. 1/

The U.K. personnel training program began with the hiring of twenty-four "core instructors" in October 1971. These individuals, who were chosen for their teaching ability, first participated in their own six-months training programs. During this time they were actively involved in the design of the value-added tax. Between April and June, 1972, the twenty-four instructors divided into six teams of four persons each and trained 30 local instructors per team. From June 1972 to April 1973, these 180 instructors covered the local areas in teams of five to six individuals. Their assignment was to train the local officials in a three-week program of lectures, workbooks, and case problems. 2/

By April 1973, the goal of training a staff of 8,000 had been met. Reviewing the training and education program, Customs and Excise officials stress the following:

1. The link between the 24 core instructors and the local offices was important in developing a clear understanding of the tax at the local level;

2. The training staff had to be constantly reeducated as changes were made in the proposed legislation;

3. The training staff had to actively contact traders and encourage them to attend the value-added tax seminars and trading associations; and

4. It is important that the materials used to educate the traders be simple and easy to understand. On more than one occasion the government training staff learned that forms and booklets which had been cleared by a trade association were unintelligible to the association's members.

1/ Ibid., p. 41.

2/ Discussion with officials of the Customs and Excise Department, Southend, April 9, 1980.

V. GENERAL VALUE-ADDED TAX SYSTEM

Because the First and Second EEC Directives established only a very general value-added tax framework, they permitted wide latitude among the Member States with respect to coverage, rates, and administrative procedures. This variation was narrowed substantially by the Sixth Directive, adopted by the EEC Council on May 17, 1977. 1/ The Sixth Directive superseded the Second Directive and became effective January 1, 1979 after a 12-month postponement. 2/ It has two objectives: to continue the progress toward the harmonization of the Member States' indirect tax systems and to implement the EEC's "own resources" program. The Directive's common definitions for such important terms as "taxable persons," 3/ "taxable transactions," 4/ "chargeable event," 5/ "taxable amount," 6/ "rates," 7/ and "exemptions" 8/ provide for more uniform value-added taxation. The Sixth Directive also covers administrative details such as record keeping and the filing of returns, 9/ and establishes "special schemes" to simplify the operation of the value-added tax system for small businessmen and farmers. 10/

1/ dePass, op. cit., p. 21.

2/ Germany adopted the Sixth Directive January 1, 1980, the last EEC country to do so.

3/ "Sixth Council Directive," Official Journal of the European Communities, June 1977, Article 4.

4/ Ibid., Articles 5, 6, and 7.

5/ Ibid., Article 10.

6/ Ibid., Article 11.

7/ Ibid., Article 12.

8/ Ibid., Article 13.

9/ Ibid., Article 22.

10/ Ibid., Articles 24 and 25.

By specifying a common value-added tax base, the Directive also provides the EEC with a major revenue source. A Council Decision of April 21, 1970 entitles the EEC to the revenues from a one percent (maximum) value-added tax on a uniform basis of assessment. 1/ These revenues are treated as a Community, rather than individual Member State, revenue source. 2/ Together with agricultural levies and customs duties, the value-added tax receipts comprise the EEC budget. To insure equal financial treatment among the Member States, the value-added tax receipts in the budget are derived from the uniform basis of assessment provided by the Sixth Directive. Until the Directive became effective, Member States contributed to the EEC on the basis of relative shares of gross national product. 3/

1. Scope. Although there are numerous exceptions, the Sixth Directive mandates a broadly-based value-added tax. It applies to the supply of goods or services by a taxable person and to the import of goods. 4/ There is no requirement that the sale or import generate a profit. Tax liability arises regardless of whether the taxable activity is carried on by an individual, partnership, or corporation.

The Directive defines a "taxable person" as anyone who "independently" acts as a producer, trader, or supplier of services, including mining, agricultural, or professional activities. 5/ These activities must be carried out on a regular or sustained basis; occasional transactions are taxed at the discretion of Member States. The requirement that a taxable person act in an "independent" capacity excludes employees from an obligation to charge value-added tax on services provided to their employers. Governmental entities are not taxable persons, except if they compete

---

1/ R. Goergen, "The Decisions of the Council of Ministers of the Community on the Proposal for a Sixth Directive on VAT," European Taxation, Vol. 17, February 1977, p. 48.

2/ "Adoption of Sixth VAT Directive," European Taxation, Vol. 17, May 1977, p. 177.

3/ Ibid., p. 177.

4/ "Sixth Council Directive," op. cit., Article 2.

5/ Ibid., Article 4, paragraphs 1 and 2.

with commercial enterprises, such as in telecommunications, the transport of goods and passengers, and the supply of water, gas, and electricity. 1/

According to the Directive, a "supply of goods" is "the transfer of the right to dispose of tangible property as [the] owner." 2/ This includes the sale of goods on an installment basis. 3/ The definition also includes the personal use of business assets, as well as the production of goods on which value-added tax would not be deductible if purchased from a taxable person. 4/ This last provision prevents the competitive distortions which arise if an exempt trader, which is not allowed to deduct tax imposed on purchases, attempts to avoid that tax by producing goods for use within its own business. A "supply of services" is defined on a residual basis; it is any transaction which is not a supply of goods. 5/ Unlike the Second Directive, the Sixth Directive does not restrict the compulsory taxation of services to those related to the supply of taxable goods. All services are taxable unless specifically exempt. The "importation of goods" is simply the entry of goods into a Member State. 6/

Although the delivery of goods or performance of services triggers a taxable event, 7/ the Directive also provides that a taxable event may arise when the supplier issues an invoice for the goods or services. 8/ The "taxable amount" is the full consideration received for the

---

1/ Ibid., Article 4, paragraph 5 and Annex D.

2/ Ibid., Article 5, paragraph 1.

3/ Ibid., Article 5, paragraph 4(b).

4/ Ibid., Article 5, paragraphs 6 and 7(a).

5/ Ibid., Article 6, paragraph 1.

6/ Ibid., Article 7.

7/ Ibid., Article 10, paragraph 2.

8/ Ibid., Article 10, paragraph 2.

supply of the good or service. 1/ It includes taxes (other then the value-added tax), duties, and incidental expenses such as packaging, transportation, and insurance costs charged to the purchaser. 2/ The taxable amount does not include discounts or rebates. 3/

2. Tax rates. Although the ultimate goal of the harmonization objective is a set of uniform Community-wide value-added tax rates, the Sixth Directive allows the Member States to continue to set their own rates. It permits each State to set a "standard rate," as well as increased or reduced rates. 4/ Imports are taxed at the same rate as their domestic counterparts. 5/ As summarized in Table 2, this discretion has resulted in a variety of Member State rates.

Only Denmark has a single rate value-added tax rate. Germany, Luxembourg, the Netherlands, and the United Kingdom have two rates; Belgium, France, and Ireland have three rates; and Italy has seven rates. The multiple-rate countries impose an increased tax burden on "luxuries" and a reduced tax burden on "necessities." Typically, higher rates apply to automobiles, furs, jewelry, and television sets and lower rates to food, clothing, and medicine. Taxable items not subject to a special rate are taxed at the standard rate, which ranges from a low of 10 percent in Luxembourg to a high of 25 percent in Ireland.

The "zero rate," used extensively by both Ireland and the United Kingdom, completely eliminates the value-added tax on a good or service. Article 17 of the Sixth Directive provides for tax liability to be determined by the invoice or deduction method. A trader's tax liability is equal to the tax charged on sales less tax paid on purchases. Any excess of input tax over output tax is either refunded or carried forward. The zero rate method applies a rate of zero to sales of the preferentially-taxed items, such as

---

1/ Ibid., Article 11, paragraph A.1(a).

2/ Ibid., Article 11, paragraph 2.

3/ Ibid., Article 11, paragraphs 3(a) and (b).

4/ Ibid., Article 12, paragraphs 3 and 4.

5/ Ibid., Article 12, paragraph 5.

Table 2

Value-Added Taxes of European Economic Community Countries: History, Rates, Coverage, and Exemptions

Country	Introduced	Tax Replaced	Rates (Percent)		Coverage 1/	Exemptions 2/
Belgium	1971	Cascade Turnover Tax	Increased 3/	25.0	Automobiles, jewelry, furs, television sets	Sale of previously-occupied immovable property; leasing of immovable property, 5/ medical, dental, and legal services; education; banking; insurance
			Standard 3/	16.0	Taxable items not subject to a special rate	
			Reduced 3/	6.0	Food, 4/ tobacco, non-motor fuels, medicine, newspapers, and books	
Denmark	1967	Wholesale Sales Tax	Standard	20.25	All taxable goods and services	Sale of previously-occupied immovable property; medical and dental services; supply of gas, water, electricity, and heating for household use; banking and insurance; education
France	1968 6/	Manufacturers' Sales	Increased	33 1/3	Automobiles, jewelry, furs, television sets	Sale of previously-occupied immovable property; leasing of immovable property, 5/ medical, dental, and legal services; education; banking and insurance
			Standard	17.6	Taxable items not subject to a special rate	
			Reduced	7.0	Food, 4/ books, medicine	
Germany	1968	Cascade Turnover Tax	Standard	13.0	Taxable items not subject to a special rate	Sale of previously-occupied immovable property; leasing of immovable property, 5/ medical and dental services; education; banking; insurance; postal services; radio and television broadcasting, except advertising
			Reduced	6.5	Food, 4/ newspapers, books, orchestra performances, legal services, municipal transportation	

Table 2 continued

Country	Introduced	Tax Replaced	Rates (Percent)		Coverage 1/	Exemptions 2/
Ireland	1972	Retail Sales Tax Wholesale Sales Tax	Standard	25.0	Taxable items not subject to a special rate	Sales of previously-occupied immovable property; leasing of immovable property, 5/ medical, dental and legal services; education; banking and insurance; broadcasting and television, except advertising; transporation of persons
			Reduced	10.0	New buildings, medicine, and goods subject to separate excise taxes, such as automobiles, motor fuel, alcohol, and tobacco, real property	
			Zero 7/	0	Food, 4/ non-motor fuel, and clothing	
Italy	1973	Cascade Turnover Tax	Increased	35.0	Jewelry, furs, large automobiles	Sale of previously-occupied structures, leasing of immovable property, 5/ medical and dental services; education; banking; insurance; public transportation, postal and telegraph services
				18.0	Beef	
			Standard	14.0	Taxable items not subject to special rate	
			Reduced	9.0	Non-luxury hotel and restaurant services	
				6.0	Food, 4/ medicines, gas and electricity for household use, low-priced housing	
				1.0	Pasta, bread	
			Zero	0	Newspapers	
Luxembourg	1970	Cascade Turnover Tax	Standard 8/	10.0	Taxable items not subject to a special rate	Sale of previously-occupied immovable property; leasing of immovable property; 5/ medical and dental services; banking; insurance; postal and telephone services
			Reduced 9/	5.0	Food, electricity and fuels for heating and lighting, books, legal services, and transportation of persons	

Table 2 continued

Country	Introduced	Tax Replaced	Rates (Percent)		Coverage 1/	Exemptions 2/
Netherlands	1969	Cascade Turnover Tax	Standard	18.0	Taxable items not subject to a special rate	Sale of previously-occupied immovable property; leasing of immovable property, 5/ medical and dental services; education; banking; insurance; radio and television broadcasting, except advertising; postal, telegraph, and telephone services
			Reduced	4.0	Food, public transportation, medicine, books	
United Kingdom	1973	Purchase Tax and selective employment tax	Standard	15.0	Taxable items not subject to the zero rate	Sale of previously-occupied immovable property; leasing of immovable property; 5/ medical and dental services; education; banking; insurance; postal services
			Zero 5/	0	Food, children's clothing, fuel and power, new buildings, transportation of persons, books	

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ The list of items covered is illustrative, not exhaustive.
2/ This lists the more important exemptions, but is not a complete list of all exemptions.
3/ Belgium law states maximum rates and allows lower rates to be set administratively. At present, the maximum rates allowed by law are: increased, 25 percent; normal, 20 percent; and reduced, 6 percent.
4/ Food purchased for on-premises consumption, such as at a restaurant, is taxed at the standard rate.
5/ The leasing of immovable property to taxable persons is a taxable transaction. This allows the lessee a deduction for tax paid to the lessor.
6/ France introduced a value-added tax in 1954-1955 as part of a general tax reform. It did not, however, apply to the retail sector or to services. This original value-added tax was substantially reformed in 1968. It now applies to all stages of production and distribution, including retail trade and services.
7/ The "zero rate" treats the taxable item as incurring a rate of zero on its sale, but allows a credit for tax paid on purchases. Thus, an item taxed at a rate of zero bears no tax. This is in contrast to an exempt transaction where no tax is charged on the sale, but no deduction or credit is allowed for tax paid on purchases.
8/ Luxembourg law allows the government, by administrative action, to increase or reduce the standard rate by two percentage points, down to 8 percent or up to 12 percent and to increase or reduce the reduced rate by one percentage point, down to 4 percent or up to 6 percent. In no case, however, may the reduced rate exceed one-half the standard rate.
9/ A special reduced rate of 2 percent applies to certain essential items in the food, dairy, and medicine categories. This rate is not part of the value-added tax law, but has been included in recent budget laws. Its intent is to provide additional tax relief on highly-essential items.

Source: International Bureau of Fiscal Documentation, Guides to European Taxation Vol. IV. Value Added Taxation Europe, Amsterdam, Current loose-leaf service.

food and clothing, but allows a full deduction for tax paid on the purchase of items related to the sale. The retail grocer's purchases of food, electricity, freezer cabinets, and other supplies probably have borne value-added tax. Allowing a full deduction for these taxes frees the grocer's food sales of value-added tax liability.

EEC officials view zero rates as incompatible with the Sixth Directive. 1/ But because it was politically impossible to eliminate them, the Sixth Directive permits the zero rates which existed on December 31, 1975 to continue until prohibited by the EEC Council. 2/ This provision applies mainly to Ireland and the United Kingdom. Although exports are zero rated in all countries (to implement the destination principles of border tax adjustment), only Ireland and the United Kingdom make extensive use of zero rates to reduce the taxation of domestic consumption.

3. Exemptions. In addition to reduced rates, the Member States also provide value-added tax relief by exemption. If a good or service is exempt, no tax is charged on its sale or supply, but no deduction is allowed for tax on purchases. Hospital and medical care, for example, is exempt under the Sixth Directive. 3/ A hospital charges no tax on its services and is allowed no deduction for tax on its purchases. In contrast to the zero rate, an exempt transaction bears some value-added tax. Tax is charged on purchases of the exempt supplier, but not on the value added by the exempt organization.

The Second Directive allowed Member States almost unlimited freedom in exempting transactions. "Each Member State may...determine the other exemptions which it considers necessary." 4/ The Sixth Directive restricts that

---

1/ Pierre Guieu, "EC: Sixth Council Directive on VAT (Uniform Basis of Assessment)," Intertax, July 1977, p. 250.

2/ "Sixth Council Directive," op. cit., Article 28, paragraph 2.

3/ Ibid., Article 13, paragraph A.1(b).

4/ "Second Council Directive," op. cit., Article 10, paragraph 3.

freedom substantially. After a transition period ending not earlier than 1983, the exemptions listed in Article 13 must be applied and no others are allowed. 1/

Article 13 exempts two general categories of activity, those performed in the "public interest" and those related to finance and real estate. Exempt activities performed in the public interest include postal services, hospital, medical, and dental care, education, cultural activities, and noncommercial radio and television. The exemption for public interest services applies irrespective of whether the service is publicly or privately provided. Both public and private schools, for example, qualify for the education exemption. Traditional government functions, such as national defense and law enforcement are also treated as exempt, although they are not covered by Article 13. According to Article 4 of the Sixth Directive, governments are not considered taxable persons when engaged in activities in pursuit of their public functions. 2/ In effect, governments are treated like final consumers, paying tax on airplanes, automobiles, furniture, and other purchases and receiving no deduction for that tax.

Article 13 also exempts insurance, banking and financial transactions, the leasing of (non-transient) immovable property (real estate), and the supply of previously-occupied buildings. Except for insurance, these exemptions are optional. The reason for the option is that value-added tax exemption is a mixed blessing. An individual tenant renting a house or apartment for residential purposes clearly benefits from not paying value-added tax on the rent. But a taxable person would prefer to pay value-added tax on space rented for business purposes since it would be deductible. If the rent was exempt, there would be no deduction, even for the value-added tax on the materials used to construct the rental space. Since the cost of the materials is reflected in the rental price, exemption creates the multiple taxation which was a classic defect of the cascade turnover taxes.

Consider, for example, a restaurant (a taxable person) with sales of $2,000 and rental expense of $1,000. For simplicity, other purchases and expenses are ignored. The following example shows the difference between treating rent as a taxable (at 10 percent) or exempt activity.

1/ "Sixth Council Directive," op. cit., Articles 13 and 28.

2/ Ibid., Article 4, paragraph 5.

	Taxable			Exempt		
	Before Tax	Tax	After Tax	Before Tax	Tax	After Tax
Sales	2,000	200	2,200	2,000	200	2,250
Rent	1,000	100	1,100	1,000	50*	1,050
Tax to Government		100			200	

(* not deductible)

If rent is taxable, the $100 in value-added tax imposed on the restaurant's rental expense may be deducted from the tax charged on its sales. The restaurant's tax-exclusive sales are $2,200 of which $200 is value-added tax. If, however, rent is exempt, no deduction is allowed. Assume that $50 in value-added tax was imposed on the "bricks and mortar" used to construct the rental space. This adds to the rental expense, but no deduction is allowed. Accordingly, the restaurant's sales now reflect $250 in value-added tax, $200 on the supply of meals and $50 embodied in the rental expense. Although the tax rate is 10 percent, the restaurant's $2,000 in sales bear $250 in value-added tax because of the cascade nature of the rent exemption.

The Sixth Directive allows Member States to avoid this problem by taxing these otherwise exempt transactions. The option need not be applied in blanket form. A Member State can exempt rents paid by non-taxable persons (either final consumers or exempt traders), but tax rents paid by taxable persons.

During the transitional period, the Sixth Directive also allows Member States to continue to tax some activities which are exempt under Article 13 and to continue to exempt some taxable activities. 1/ Member States, for example, may continue to tax dental services, cultural activities, and certain financial transactions. 2/ Similarly, they may

---

1/ *Ibid.*, Article 28, paragraph 3.

2/ *Ibid.*, Annex E.

continue to exempt admissions to sporting events, legal services, passenger transport, and the supply of new buildings. 1/

Notwithstanding these transitional exceptions, the Member States already have complied substantially with the basic exemption provisions of the Sixth Directive. This is illustrated by Table 2, which summarizes the significant exemptions of the Member States. All of the countries, for example, exempt the sale of previously-occupied immovable property (real estate), medical and dental services, banking, and insurance. All except the United Kingdom tax the sale of new buildings. Nearly all exempt the leasing of non-transient immovable property (real estate), except to taxable persons.

4. Special schemes. The EEC value-added tax requires a taxable person to maintain records of his sales and purchases, as well as of the tax charged on those transactions. This information either is required as part of a taxpayer's value-added tax return or in support of the figures on the return. But maintaining such records may be beyond the capabilities of retailers and other small taxpayers. As explained in a United Kingdom publication, "most retailers cannot keep a record of that kind for all their sales, because they do not usually issue invoices to their customers or make any written record at the time when a sale takes place." 2/ Unlike the United States where the use of cash register receipts by small retailers is commonplace, many European retailers do not issue a receipt for individual transactions. Farmers are another group that may not normally have the sales and purchase information necessary to file a value-added tax return. In recognition of these problems, the Sixth Directive authorizes Member States to apply special value-added tax schemes to small businesses and farmers.

a. Small businesses. Article 14 of the Second Directive allowed Member States to apply "the special rules best suited to national requirements and possibilities" to

---

1/ Ibid., Annex F.

2/ Her Majesty's Customs and Excise, Value Added Tax: Special Schemes for Retailers, Notice No. 727, London, printed in England for Her Majesty's Stationery Office by McCorquodale Publishers, Ltd., 1977, p. 5.

small enterprises. 1/ Article 24 of the Sixth Directive reiterates this option, allowing Member States to use "simplified procedures such as flat-rate schemes for charging and collecting the tax," but requires that there be no tax reduction involved. 2/ Unlike the reduced rates and exemptions applied to some activities, the intent of this provision is to reduce the administrative burden on small enterprises, but not the taxes that normally would be charged on the goods and services they supply.

Article 24 also allows Member States to exempt taxable persons with an annual turnover of less than 5,000 European units of account ($7,100). 3/ States offering a larger exemption when the Directive was adopted may maintain it in real or price-adjusted terms. 4/ Unlike the flat-rate schemes for any small enterprise, the sales-related exemption aims at both tax reduction and administrative simplification. In response to these small business provisions, the Member States have adopted a variety of methods.

Some states provide an exemption for taxpayers with business activity below a threshold level. Usually, the exemption is not mandatory; small enterprises selling to taxable persons may elect to be taxable. The Netherlands exempts individuals and partnerships with an annual value-added tax liability less than Dfl 2,050 ($1,000). 5/ U.K. traders with less than £13,500 ($32,000) in annual sales are exempt from value-added tax. 6/

Other States allow an exemption, but with certain qualifications. Irish law provides varying exemption levels based on a trader's sales, purchases, and type of activity.

1/ "Second Council Directive," op. cit., Article 14.

2/ "Sixth Council Directive," op. cit., Article 24, paragraph 1.

3/ Ibid., Article 24, paragraph 2(a).

4/ Ibid., Article 24, paragraph 2(c).

5/ International Bureau of Fiscal Documentation, op. cit., Netherlands, Section 6.3.3.3.

6/ Discussion with officials of the Customs and Excise Department, London, April 8, 1980.

The exemption is available for enterprises with 2-month sales ranging between £500 ($1,100) and £3,500 ($7,400). 1/ The exemption threshold is higher for goods than for services and for goods taxed at a low rate than for items taxed at the standard rate. Small businesses in the Netherlands with annual tax liability between Dfl 2,050 ($1,100) and Dfl 4,150 ($2,200) pay a reduced rate of value-added tax. 2/

Belgium exempts small retailers, but applies an equalization tax on their purchases to compensate for the value of the exemption. The equalization tax is imposed on the small retailer's supplier and is equal to either 15 percent or 33 percent of the value-added tax normally imposed on the retailer's purchases. 3/ This option is available to non-corporate retailers with annual purchases less than Bfrs 2.5 million ($75,000) or to retailers with less than Bfrs 4.5 million ($135,000) in annual purchases who sell primary food products. Although an exempt trader is not normally allowed to deduct tax imposed on purchases, a retailer exercising this option may still deduct tax imposed on investment goods. 4/

Member States also provide small business relief in the form of lump-sum taxation and relaxed requirements relating to the filing of returns. Belgium allows small traders, not just retailers, to be taxed on a fixed amount based on such factors as labor costs, profit margins, and unit sales prices. 5/ This option is available to non-corporate taxpayers with annual sales less than Bfrs 15 million ($450,000) made mostly to final consumers. 6/

1/ Office of Revenue Commissioners, Guide to the Value-Added Tax, Dublin, 1979, p. 22.

2/ International Bureau of Fiscal Documentation, op. cit., Netherlands, section 6.3.3.3.

3/ Ibid., Belgium, section 6.3.3.3.

4/ Ibid., Belgium, section 6.3.3.3.

5/ Ibid., Belgium, section 6.2.3.6.

6/ Ibid., Belgium, section 6.2.3.6.

Italian retailers with less than 6 million lire ($7,200) in annual sales are not required to maintain detailed sales and purchase records. 1/ Value-added tax liability is based on gross sales minus a surrogate deduction for tax imposed on purchases. The amount of the lump-sum purchase tax deduction depends on the seller's business activity. In contrast to the normal monthly filing requirement, taxpayers with annual sales of less than 480 million lire ($576,000) may file returns on a quarterly basis. 2/

United Kingdom retailers may choose from nine schemes designed to eliminate the need to issue an invoice for each separate transaction. Although records must be maintained of tax imposed on purchases, a retailer may determine his output tax on the basis of gross sales. If sales are taxed at multiple rates, output is apportioned in relation to purchases. If, for example, three-fourths of a taxpayer's purchases are for items taxable at a zero rate and one-fourth for items taxable at a reduced rate, it is assumed that actual sales were taxed in this same proportion. 3/

b. Farmers. Farmers are another group that may lack the detailed records necessary for a value-added tax return. Unlike the vast majority of small businesses, this administrative problem cannot be solved by merely establishing a sales exemption level. Whereas most small businesses sell to final consumers, farmers sell primarily to food processors, wholesalers, and other taxable persons. Consequently, an outright exemption for farmers will deprive their customers of a deduction for the taxes the farmers have paid on their seed, fertilizer, tractors, and other purchases.

Article 25 of the Sixth Directive recognizes this problem and provides for a special flat-rate system "where the application to farmers of the normal value-added tax

---

1/ Discussion with officials of the Italian Ministry of Finance, Rome, March 26, 1980.

2/ Discussion with officials of the Italian Ministry of Finance, Rome, March 26, 1980.

3/ Her Majesty's Customs and Excise, Value-Added Tax: Special Schemes for Retailers, op. cit., pp. 13-23.

scheme...would give rise to difficulties." 1/ Relying on sales and purchase information in the agricultural sector, Member States specify percentage figures reflecting the value-added taxes imposed on farmers' purchases. This percentage is charged by farmers on their sales and is deductible by the farmers' customers.

This method, which has been generally accepted by the Member States, keeps farmers within the value-added tax system, but does not require them to file a tax return. The flat-rate percentage compensates the farmers for the tax paid on their purchases. Allowing their customers to deduct the compensation levy insures the deductibility of value-added tax paid by farmers. In effect, the deduction which would otherwise be available to the farmers is passed forward to their customers.

5. Specific transactions. The value-added tax specified by the EEC applies to most, but not all, consumer expenditures. Most services provided by financial institutions and insurance companies are exempt. Sales of previously-occupied immovable property (real estate) are exempt and the leasing of immovable property (real estate) is exempt in many cases. Nonprofit organizations carrying on activities in the public interest are exempt. Governments are not considered taxable persons, unless they carry on commercial activities. Although a consumption type value-added tax would allow tax imposed on investment goods to be deductible, this deduction has been limited in some cases.

a. Banking and finance. As indicated in Table 2, the Member States follow the the Sixth Directive and exempt most banking transactions. All Member States, for example, exempt the lending of money; no value-added tax is imposed on the interest charge. Final consumers and exempt persons benefit from being able to borrow tax free, but taxable persons do not since they would be able to deduct any tax charged on a business loan. Exemption thus creates an element of multiple taxation since neither the borrower nor lender may deduct taxes imposed on the bank's purchases.

Some bank activities, such as the rental of safe deposit boxes and the providing of investment advisory services, are taxable. Unlike their exempt activities, banks are allowed

---

1/ "Sixth Council Directive," op. cit., Article 25, paragraph 1.

to deduct value-added tax imposed on purchases associated with these taxable services. In determining the allowable deductions, Member States rely on both tracing and apportionment rules. Some items, such as safe deposit boxes or the furniture for the consumer loan department are clearly related to a particular bank activity. The deductibility of tax paid on these purchases depends on whether or not the activity is taxable. Other purchases, such as a computer, are broadly related to a bank's entire range of activities. In this case, Member States only allow a deduction that reflects the use of the computer in taxable activities. If four-fifths of the computer's time is used in exempt activities and one-fifth in taxable activities, only one-fifth of the tax is deductible.

b. Insurance. All Member States exempt insurance transactions, as allowed by the Sixth Directive. 1/ Insurance companies are not taxed on their delivery of insurance services, nor are they allowed to deduct value-added tax imposed on purchases related to the delivery of those services.

The effects of the insurance exemption are parallel to those in the banking and finance area. Although exempt persons and final consumers benefit from buying insurance on an exempt basis, the impact on taxable persons may be adverse because of the multiple taxation problem.

Like banks, insurance companies may be tempted to avoid value-added tax by providing goods and services with their own employees. Janitorial and security services, for example, would be taxed if purchased from a taxable person. The Sixth Directive recognizes this possibility and authorizes Member States to tax self supplies. 2/ An official of the German Ministry of Finance cautioned, however, that this provision is invoked only in response to egregious abuses since it complicates the administration of the tax. 3/

1/ Table 2.

2/ "Sixth Council Directive," op. cit., Article 5, paragraph 7(a).

3/ Discussion with officials of the German Ministry of Finance, Bonn, March 20, 1980.

c. Immovable property. After a transition period ending no earlier than December 31, 1983, the Sixth Directive taxes the sale of new buildings (including residential housing) and exempts the sale of previously-occupied buildings. 1/ New buildings are generally defined as not previously occupied structures, but may be alternatively defined by the Member States. An exception is provided for occasional sales of immovable property, which Member States may tax or exempt at their discretion. 2/ Once this rule becomes mandatory, value-added tax will be charged on the sale of a new building and the seller will receive a deduction for taxes imposed on the bricks, lumber, glass, electrical supplies, and other items purchased to construct the building. A taxable person is entitled to a deduction for tax paid on the purchase of the building. No deduction is allowed if the purchaser is an exempt person or a final consumer.

In effect, the Sixth Directive taxes the initial sale of a new building, then cuts the chain. Thus, the sale of a previously-occupied building is exempt. In most cases, the exemption for used buildings works with the taxation of new buildings to fulfill the objective of taxing final consumption of building services. Exempting used buildings, even if purchased by a taxable person, does not create a multiple tax problem since the original business purchaser deducted the tax imposed on the new building. Similarly, since tax is charged on the first sale of a building to a final consumer, no additional taxation is necessary. Any appreciation in immovable property is not taxed under this system. Conversions from personal to business use, or vice versa, may present a problem, but the options in the Sixth Directive appear sufficient either to prevent double taxation or to permit the taxation of building services used by consumers.

Many of the EEC countries already tax the supply of new buildings. Belgium, for example, levies its standard 16 percent value-added tax rate on the sale of new buildings and subjects used structures to a 12.5 percent registration

---

1/ "Sixth Council Directive," op. cit., Articles 4, 13 and 28.

2/ Ibid., Article 4, paragraph 3(a).

tax. 1/ Ireland applies its reduced 10 percent value-added tax rate, but to 30 percent of the value of new buildings. 2/ The effective tax of 3 percent corresponds with the sales tax burden on building materials under the previous system. 3/ Italy taxes new buildings at the standard 14 percent value-added tax rate and old buildings bear a separate registrar tax of 10 percent. 4/ Similarly, the Netherlands applies its standard 18 percent value-added tax rate to new buildings and a separate tax to the sale of other immovable property. 5/ Germany exempts all real estate because it is subject to a separate acquisition tax, but the seller may opt for inclusion in the value-added tax system. 6/ New buildings are taxed at a zero rate in the United Kingdom; thus housing purchased by final consumers is free of any U.K. value-added tax. 7/

According to the Sixth Directive, the leasing of immovable property is exempt, although suppliers of rental property may elect to be taxable. As indicated by Table 2, nearly all Member States exempt the leasing of immovable property, except if the property is leased to a taxable person. In that case, the lessor may elect to be taxable, thus allowing a lessee who is a taxable person to deduct taxes paid to the lessor. Any discrimination between the consumer's choice to own or rent is probably minimal.

1/ Price Waterhouse, op. cit., pp. 20 and 22.

2/ Office of the Revenue Commissioners, Guide to the Value-Added Tax, op. cit., p. 56.

3/ Discussion with officials of the Office of Revenue Commissioners, Value-Added Tax Branch, Dublin, March 10-11, 1980.

4/ Discussion with officials of the Italian Ministry of Finance, Rome, March 26, 1980.

5/ International Bureau of Fiscal Documentation, op. cit., Netherlands, sections 1.2, 5.2, and 6.3.

6/ Ibid., Germany, section 5.2.1

7/ Her Majesty's Customs and Excise, Value-Added Tax: Scope and Coverage, Notice No. 701, London, printed in England for Her Majesty's Stationery Office by McCorquodale Publishers, Ltd., 1979, p. 24.

Although residential rents are exempt, value-added tax is charged on the first sale of a new building, whether rental property or owner occupied.

d. Nonprofit organizations. The typical nonprofit organization, providing charitable, educational, scientific or similar services only pays value-added tax on its purchases. This is a consequence of carrying on an exempt activity in the public interest. 1/ Member States, however, exercise the right provided by the Sixth Directive to tax nonprofit organizations that provide goods and services in direct competition with the commercial sector.

e. Government provided goods and services. The EEC countries exempt government-provided goods and services, except if supplied in competition with commercial operations. This treatment is consistent with the Sixth Directive. According to Article 4, governments "shall not be considered taxable persons" except "where treatment as nontaxable persons would lead to significant distortions of competition." 2/ The objective is to provide tax equity between privately and publicly supplied goods and services. Thus, the supply of electricity, gas, and other utilities, the transportation of goods and passengers, and telecommunication services are taxable regardless of the legal status of the supplier. 3/

f. Investment goods. In contrast with the cascade turnover taxes which applied to investment goods, the First and Second EEC Directives specified a consumption-type value-added tax. Taxable persons were allowed to deduct value-added tax imposed on the purchase of investment goods. But to dampen any incentive for taxable persons to postpone their capital purchases, the Second Directive allowed Member States "to exclude, wholly or in part, for a certain transitional period, capital goods from the deduction provided for in Article 11." 4/ Although this transitional period has now expired, the Sixth Directive allows Member States to

---

1/ "Sixth Council Directive," op. cit., Article 13.

2/ Ibid., Article 4, paragraph 5.

3/ Ibid., Annex D.

4/ "Second Council Directive," op. cit., Article 17.

restrict the deductibility of tax on investment goods for cyclical reasons. 1/ Many of the Member States have taken advantage of these options.

When Belgium introduced the value-added tax in 1971, 10 percentage points of the 18 percent value-added tax imposed on capital goods were not deductible. 2/ If Bfrs 18,000 in value-added tax was imposed on the purchase of a Bfrs 100,000 machine, only Bfrs 8,000 was deductible. Although Belgian authorities recall that the deduction was restricted because of "fear over an investment stop," they also cite other reasons. A pure consumption value-added tax would have placed too great a burden on consumers. The new system already imposed more tax on Belgian consumers and less on foreign consumers because export rebates had been too low under the turnover tax regime. The tax on capital goods also helped finance the revenue loss from the lower rates on necessities. Although the deductible proportion has increased since 1971, 5 percentage points of the current 16 percent value-added tax are still non-deductible for most investment purchases. 3/ This is done mainly for revenue reasons.

Although Germany always allowed a full credit for value-added tax on capital goods, it addressed the transitional problem by imposing a separate non-creditable tax on investment purchases. In effect, this was a separate turnover tax on capital goods. It was levied at either 5.5 percent or 11 percent and was phased out in 1973. 4/ Ireland did not adopt any specific transitional measures, but does deny the deductibility of tax paid on automobiles because of the difficulty of separating business from personal use. 5/ During the transition to the value-added tax, Italy exempted investment goods from the cascade turnover tax to avoid any disruption of investment plans. Accordingly, it was not

---

1/ "Sixth Council Directive," op. cit., Article 17, paragraph 7.

2/ International Bureau of Fiscal Documentation, op. cit., Belgium, section 9.2.1.

3/ Ibid., Belgium, Section 9.2.

4/ Ibid., Germany, section 9.2.

5/ Ibid., Ireland, section 6.4.5.

necessary to restrict the deductibility of value-added tax. 1/ The introduction of the value-added tax in the Netherlands was accompanied by a refund of turnover tax paid on stocks and inventories, but not capital equipment. Both to finance these refunds and provide parallel taxation of new investment purchases, only a partial capital equipment deduction was allowed for the first few years of the value-added tax. 2/ A full deduction is now available for capital goods.

1/ Discussion with representatives of Italian Trade Association, Rome, March 25, 1980.

2/ Millenaar, op. cit., p. 12.

VI. ADMINISTRATIVE ASPECTS

As Dorothy Johnstone observes in her study of the U.K. value-added tax, "ease of administration could [not] be reckoned among VAT's merits." 1/ The EEC tax and deduction method creates substantial paperwork without generating any tax revenue. No tax is collected on transactions between taxable persons because the tax charged by the seller is deducted by the purchaser. Nonetheless, all taxable transactions must be carefully recorded. Invoices must be issued so that the purchaser can deduct the tax charged on the sale. Returns must be filed periodically and taxes paid. The treatment of excess purchase tax deductions may affect a taxpayer's cash flow position. Increased rates on luxuries and reduced rates on necessities require determinations of the commodities in these categories. Although some contend the value-added tax is "self-enforcing," it has certain fraud-prone areas and requires an active enforcement effort.

1. Basic administrative mechanism. Registration with the value-added tax authorities is the initial step in the administrative process. The Belgian requirement is typical.

> A taxpayer must register at the TVA office in the district in which he resides when he commences or discontinues taxable activities. At the commencement of taxable activities, the taxpayer receives a TVA registration number which identifies him as a taxpayer and must be used by him in all correspondence with the tax administration. 2/

All EEC Member States follow the Sixth Directive and consider tax chargeable either when goods are delivered and services performed or when an invoice is issued. Frequently, the determination of the precise tax point depends on the tax status of the customer. In Ireland, for example, sales to taxable persons are taxable when the invoice is issued, but sales to exempt persons and final consumers are

---

1/ Johnstone, op. cit., p. 5.

2/ International Bureau of Fiscal Documentation, op. cit., Belgium, section 8.1.

taxable when the goods or services are supplied. 1/ The Netherlands and the United Kingdom make a similar distinction. To avoid delaying payment of the tax, an invoice must be issued within a certain time. Belgium, for example, allows five days after the end of the month in which the item is supplied; 2/ the United Kingdom 30 days after the date of supply. 3/

At the end of the taxable period, a return must be filed and any tax liability must be paid. The basic tax period is one month in Belgium, 4/ Germany, 5/ and Italy, 6/ two months in Ireland, 7/ and three months in the Netherlands 8/ and the United Kingdom. 9/ The taxable period is often longer for small traders, but shorter for taxpayers normally expecting a refund of tax. Belgian taxpayers, for example, having an annual turnover of less than Bfrs 15 million ($500,000) may file quarterly, but must still make monthly tax payments. 10/ German traders with a previous year's value-added tax liability of less than DM 2,400 ($1,300) may

---

1/ Office of the Revenue Commissioners, Guide to the Value-Added Tax, op. cit., p. 33.

2/ Price Waterhouse, op. cit., p. 23.

3/ Her Majesty's Customs and Excise, Value-Added Tax: General Guide, Notice No. 700, printed in England for Her Majesty's Stationery Office by McCorquodale Publishers, Ltd., 1979, p. 34.

4/ International Bureau of Fiscal Documentation, op. cit., Belgium, section 8.1.2.

5/ Ibid., Germany, section 8.1.

6/ Ibid., Italy, section 8.1.2.

7/ Office of the Revenue Commissioners, Guide to the Value-Added Tax, op. cit., p. 36.

8/ Price Waterhouse, op. cit., p. 65.

9/ Her Majesty's Customs and Excise, Value-Added Tax: General Guide, op. cit., p. 51.

10/ International Bureau of Fiscal Documentation, op. cit., Belgium, section 8.1.2.

file quarterly returns. 1/ Ireland 2/ and the United Kingdom 3/ permit traders in a continuing repayment position, such as exporters, to accelerate their refund by filing monthly. The due date for the return and payment varies from five days after the close of the taxable period in Italy, 4/ to one month in the Netherlands 5/ and the United Kingdom. 6/ Chart 2 illustrates the one-page value-added tax return used by the United Kingdom.

2. Invoice. The invoice issued on all transactions between taxable persons is a vital element in the operation of the EEC value-added tax systems. "The information given on invoices and credit notes normally establishes the tax liability of the supplier of goods or services and the entitlement of the customer, if he is a taxable person, to a deduction for the tax charged." 7/ The Sixth Directive requires that an invoice must exist to support the right to deduct value-added tax 8/ and that "Member States shall determine the criteria for considering whether a document serves as an invoice." 9/

1/ Price Waterhouse, op. cit., p. 42.

2/ Office of Revenue Commissioners, Guide to the Value-Added Tax, op. cit., p. 37.

3/ Her Majesty's Customs and Excise, Value-Added Tax: General Guide, op. cit., p. 51.

4/ Price Waterhouse, op. cit., p. 54.

5/ International Bureau of Fiscal Documentation, op. cit., Netherlands, section 8.1.

6/ Her Majesty's Customs and Excise, Value-Added Tax: General Guide, loc. cit., p. 51.

7/ Office of the Revenue Commissioners, Guide to the Value-Added Tax, op. cit., p. 40.

8/ "Sixth Council Directive," op. cit., Article 18, paragraph 1(a).

9/ Ibid., Article 22, paragraph 3(c).

Chart 2

H M Customs and Excise

Return of Value Added Tax

For the period

..... to ....

These dates must not be altered without the agreement of Customs and Excise

For Official Use

Registration No. | Period

The person named here must complete the whole of this form (writing "none" where appropriate), in accordance with the instructions contained overleaf and return it in the enclosed envelope to the Controller, VAT Central Unit, H M Customs & Excise, 21 Victoria Ave., SOUTHEND-ON-SEA X.

not later than

The tax payable must be paid by the same date by remittance enclosed with this form or by National or Bank Giro.

WARNING

A return which is incomplete or qualified in any way (e.g. marked "Provisional") does not satisfy the legal requirements. Failure to make a return or to pay the full amount of tax payable by the due date is an offence.

Fold here

FOR OFFICIAL USE

Account of tax payable or repayable

		£	p
TAX DUE in this period on OUTPUTS (sales, etc.)	1		
Tax due on imported goods, goods from bonded warehouses and services received from abroad	2		
Underdeclarations and/or underpayments of tax in previous periods notified in writing by Customs and Excise	3		
Other underdeclarations made on previous returns	4		
(Total of boxes 1,2,3 and 4) **TOTAL TAX DUE**	5		
TAX DEDUCTIBLE being the credit claimed in this period for input tax allowable (on purchases, etc.)	6		
Overdeclarations and/or overpayments of tax in previous periods notified in writing by Customs and Excise	7		
Other overdeclarations made on previous returns	8		
(Total of boxes 6,7 and 8) **TOTAL TAX DEDUCTIBLE**	9		
NET TAX PAYABLE OR REPAYABLE *(Difference between boxes 5 & 9)*	10		

Please tick the following boxes if 'YES' is appropriate:

Box 8 includes bad debt relief ☐

Box 11 includes exempt outputs ☐

Box 11 includes exports ☐

Value of Outputs (sales, etc.) *(excluding any Value Added Tax)*	11		.00
Value of Inputs (purchases, etc.) *(excluding any Value Added Tax)*	12		.00

Special schemes for Retailers (Notice No. 727)

If you have used any of the schemes in the period covered by this return please tick the appropriate box(es) to show all the scheme(s) used.

A B C D E F G H J

Please tick ONE only of the following boxes:

If box 5 is greater than box 9 : Payment by Giro ☐ Payment enclosed ☐

If box 9 is greater than box 5 : Repayment due ☐

Declaration by the signatory to be completed by or on behalf of the person named above.

I, ... declare that the
(full name of signatory in BLOCK LETTERS)

information given in this return is true and complete.

Signed..... Date.....

*(Proprietor, partner, director, secretary, responsible officer, member of club or association, duly authorised person) ***Delete as necessary***

A taxable person's right to deduct value-added tax depends solely on the existence of an invoice; he does not need to have paid his supplier or sold the goods to deduct the tax. Because of the crucial role of the invoice, the Member States carefully specify its content. The United Kingdom, for example, requires an invoice to show the following: an identifying number; date of supply; seller's name, adddress, and value-added tax registration number; customer's name and address; type of supply; identifying description of items supplied; for each item, the quantity supplied, rate of tax, and amount payable; total amount payable (excluding value-added tax); cash discount, if any; and the total value-added tax charged. 1/ Chart 3 is a sample of one type of invoice accepted by the U.K. Customs and Excise Department. EEC taxpayers are not required to attach invoices to the tax return, but must keep them for possible inspection by the tax authorities.

3. Excess deductions. With the invoice type value-added tax, a taxpayer's deductible tax may exceed the tax due on sales. In the United Kingdom, for example, about 30 percent of the 1.25 million registered traders chronically have input tax exceeding their output tax. 2/ An embryonic business incurring heavy capital expenditures, but having modest sales, may be in this situation. Since all Member States apply a zero rate to export sales, exporters normally have excess tax deductions. The same is true of grocers in Ireland and the United Kingdom selling zero rated food products. In excess deduction situations, the Sixth Directive provides that "Member States may either make a refund or carry the excess forward." 3/

1/ Her Majesty's Customs and Excise, Value-Added Tax: General Guide, op. cit., pp. 34-35.

2/ Commissioners of Her Majesty's Customs and Excise, Review of Value Added Tax, op. cit., p. 8.

3/ "Sixth Council Directive," op. cit., Article 18, paragraph 4.

Chart 3

Illustration of a Value-Added Tax Invoice

SALES INVOICE No. 74 — 14 August 1979

To A Retailer Ltd.
48 North Road, London N12 5NA.
From: Foundation Trading (UK) Ltd.
Bowman Street, Chester. VAT Regd. No. 987 6543 21
Sale

Quantity	Description and Price	Amount exclusive of VAT	VAT Rate	VAT Net
		£	%	£
6	Radios, SW14 at £21.30	127.80		
12	Record Players P38 at £9.80	117.60		
6	Amplifiers J27 at £11.80	70.80		
		316.20	15	45.06*
	Delivery (strictly net)	6.00	15	0.90
Terms: Cash Discount of 5% if paid within 14 days		322.20		45.96
	VAT	£45.96		
Tax Point: 14/8/1979	TOTAL	£368.16		

*Calculated on the discounted price.

Source: Her Majesty's Customs and Excise, Value-Added Tax: General Guide, Notice No. 700, 1979, p. 76.

The Member States are split in response to these options. Germany, 1/ Ireland, 2/ the Netherlands, 3/ and the United Kingdom 4/ provide an immediate refund of any excess deductions. Germany even asks the taxpayer to enter the refund amount on the return in red ink in the belief that this enhanced visibility will prevent the refund claim from being overlooked. Belgium requires excess deductions to be carried forward to the next month, but refunds any balance of at least Bfrs 60,000 ($2,000) at the end of each quarter. Small taxpayers filing on a quarterly basis receive a full refund if the excess deductions are at least Bfrs 25,000 ($800). For all taxpayers, any balance of at least Bfrs 300 ($10) is refunded at the end of the year. 5/ Italian exporters must carry excess deductions forward to the next month, but are eligible for a refund at the end of each quarter. 6/ For all other taxpayers, Italy only refunds excess deductions at the end of the year. 7/

4. Cash flow. Although value-added tax liability is usually determined on an invoice basis, the value-added tax does not directly affect the cash flow position of taxable persons. Value-added tax is paid on the basis of a taxable person's sales and purchase invoices. There is no requirement that the tax charged on sales has actually been

---

1/ International Bureau of Fiscal Documentation, op. cit., Germany, sections 6.4 and 8.2.

2/ Office of the Revenue Commissioners, Guide to the Value-Added Tax, op. cit., p. 37.

3/ International Bureau of Fiscal Documentation, op. cit., Netherlands, section 8.2.

4/ Her Majesty's Customs and Excise, Value-Added Tax: General Guide, op. cit., p. 51.

5/ International Bureau of Fiscal Documentation, op. cit., Belgium, Section 8.2.

6/ Discussion with officials of the Italian Ministry of Finance, Rome, March 26, 1980.

7/ International Bureau of Fiscal Documentation, op. cit., Italy, section 8.2.

collected or that the tax invoiced on purchases has actually been paid. A taxpayer's credit terms, however, may combine with the invoice method to affect his cash flow position.

The United Kingdom, for example, requires the tax return to be filed and tax paid one month after the end of the three-month taxable period. 1/ The return and payment for the January-March period are due by May 1st. A U.K. trader who receives prompt payment from his customers and who also pays his suppliers promptly will realize an improved cash flow position from the value-added tax.

On average, he will have two and one-half months use of his value-added tax liability before paying it to the Customs and Excise Department; from the middle of the three-month period, February 15th, until May 1st. "Generally speaking, this gives a cash flow advantage to traders, most of whom collect the tax from their customers before it is due to be paid to the Department." 2/ The period of cash flow benefit will change with the relative credit terms accorded a taxpayer's customers and suppliers. The maximum cash flow benefit is realized by those taxpayers who receive prompt payment from their customers, but are able to delay paying their suppliers.

Cash flow is also affected by a country's policy with respect to excess deductions. A country like Italy, which only refunds excess deductions at the end of the year, effectively requires taxpayers to finance the cost of any excess purchase tax payments.

5. Multiple rates. Only Denmark has a single rate value-added tax. The rest of the EEC countries have multiple rate systems that tax luxuries at higher rates or necessities at reduced rates. Multiple rates may improve the equity of the tax, but they clearly increase its administrative costs. The revenue authorities must draw precise and understandable boundaries between various groups of items.

1/ Her Majesty's Customs and Excise, Value-Added Tax: General Guide, loc. cit.

2/ Commissioners of Her Majesty's Customs and Excise, Review of Value Added Tax, op. cit., p. 15.

Specially-taxed items must sometimes be described in great detail. Ireland taxes bread at a zero rate, but biscuits, crackers, and cakes at a different rate. Taxpayers are instructed that "the zero rate normally applies, therefore, to loaves, turnovers, pan loaves, soda bread, brown bread, vienna rolls, french sticks, bread rolls, some fruit loaves, bread scones, etc. [However,] confectionery, cakes, barm bracks, biscuits, cream crackers, wafers, crispbreads, etc. are liable at the low rate." 1/ These distinctions can be made, but they require a good deal of time and effort.

Relying on more simple solutions may produce anomalous results. The United Kingdom zero rates all items of clothing "which are for young children of average size up to their 12th birthday." 2/ Based on this criterion alone, small-sized adults can buy clothing tax free. A recent British entrant in the "Miss World" contest, for example, satisfied the 12-year old size requirement.

6. Relation to income tax. The EEC Member States differ in the degree to which they combine administration of the value-added tax with the income tax. Although joint administration may be cost-effective, there may be important traditional reasons for relying on separate efforts.

Belgium relies on a separate administrative mechanism for the value-added tax, but permits information to be exchanged with the income tax authorities. 3/ The value-added and income taxes are jointly administered in Germany, an arrangement that contributes significantly to the effective operation and enforcement of each tax. 4/ Italy uses the information on a taxpayer's value-added tax return

---

1/ Office of the Revenue Commissioners, Guide to the Value-Added Tax, op. cit., p. 83.

2/ Her Majesty's Customs and Excise, Value-Added Tax, Scope and Coverage, op. cit., p. 62.

3/ Price Waterhouse, op. cit., p. 24.

4/ Discussion with officials of the German Ministry of Finance, Bonn, March 20, 1980.

to verify the taxpayer's income tax liability. 1/ The Netherlands relies on separate systems at the lower and middle levels of control, but combines administration at the higher control levels. The judicial appeal procedure is the same for both taxes. 2/

Ireland and the United Kingdom perhaps represent the polar extremes of joint and separate administration. A single Board administers all Irish taxes. Administration and control of the Irish value-added tax is linked with that of the income tax. Irish law permits the full exchange of information with respect to the two taxes. Collection of each tax is in the hands of the Collector-General and the judicial appeal machinery is the same for each tax. Local control of the value-added tax is provided through the local income tax offices. An Irish taxpayer's income and value-added tax returns are compared for possible discrepancies. 3/

In contrast to the U.K. income tax which is administered by the Inland Revenue Department, the Green Paper announced that "VAT will be administered by HM Customs and Excise." 4/ There were three reasons for assigning value-added tax responsibility to Customs and Excise rather than Inland Revenue. The elimination of the purchase tax freed 2,000 Customs and Excise Department employees for other duties. In addition, the adoption of the corporation tax and the capital gains tax had greatly increased Inland Revenue's workload. Most important, however, was Customs and Excise's expertise in the turnover tax area. "The clinching factor was the inevitability of the 'invoice method.' Although our advance knowledge of the prospective taxpaying population was much inferior to Inland Revenue's, for a tax that was to

---

1/ Discussion with officials of the Italian Ministry of Finance, Rome, March 26, 1980.

2/ Discussion with officials of the Netherlands Ministry of Finance, The Hague, March 12, 1980.

3/ Office of Revenue Commissioners, Value-Added Tax Branch, "Value-Added Tax," unpublished paper, pp. 6-8.

4/ Value-Added Tax, Green Paper, op. cit., p. 12.

be based on transactions and invoices rather than on accounts our actual tax-gathering techniques, especially in the purchase tax, were an altogether close fit." 1/

The administration of the two taxes is not completely divorced since section 127 of the Finance Act of 1972 provides for the exchange of information between Inland Revenue and Customs and Excise. Parliament accepted this provision, however, only after being assured that control would be exercised at the "appropriate level" and that "no Customs and Excise Staff would spend all or most of their time in cross-checking with Inland Revenue and that VAT returns would not be compared with accounts submitted to Inland Revenue as a matter of routine." 2/

7. Enforcement. Although a taxable person has a strong interest in having the value-added tax imposed on his purchases accurately recorded on the invoice he receives, this does not mean that the tax is self-enforcing.

> VAT is indeed a different tax from purchase tax, and some people have supposed on a superficial acquaintance with it that its credit mechanism, in which the output tax to be paid by one taxpayer is commonly the deductible input tax of another, ought to have the effect of enlisting the customer as an auxiliary policeman: he will want to make sure that he is given an invoice that shows the right amount of tax. But on closer study one soon realizes that there is little substance in that, for once the customer has got the evidence to support his own deduction claim there is no self-interest that will prompt him to inquire whether his supplier is actually proposing to pay that same amount of tax over to the tax authority.... In any event there is no self-policing feature, even in principal, at the last of the VAT stages, where registered businesses are selling goods or providing services to unregistered customers who are not allowed to claim deductions. We do not think,

---

1/ Johnstone, op. cit., p. 9.

2/ Ibid., p. 73.

> therefore, that we were being too pessimistic or departmentally hide-bound in placing little weight on the theory that VAT might police itself. 1/

Like any tax, the value-added tax has certain difficult to control and fraud-prone areas which require an active enforcement effort. The retail stage is perhaps the most obvious. Because of the absence of sales invoices, a taxpayer may be able to minimize his tax liability by suppressing his sales volume. An awareness of retail margins helps control this problem, but does not eliminate it. This is especially true in hotels, restaurants, repair activities, and other services where a high proportion of the value added is produced at the final stage and there is little input tax to trace or check. Construction is another troublesome area. Transient subcontractors may charge value-added tax on their services, but not remit it to the revenue authorities. False purchase invoices may enable a taxpayer to improperly claim a deduction for taxes not paid. This problem is compounded when combined with a zero rated business activity, such as exporting, since a tax refund will be forthcoming if the false claim is undetected. The personal use of business assets needs to be monitored closely. A taxpayer withdrawing a typewriter or television set from his inventory and using it in his own home will enjoy tax-free use of the item if he fails to charge value-added tax on the withdrawal.

Irish and United Kingdom tax authorities stress the importance of control visits to taxpayers in effectively enforcing the value-added tax. 2/ On-sight visits provide tax authorities with valuable impressions and a practical understanding of a taxpayer's business which may be unavailable from simply reviewing the tax return. During the visits, value-added tax officers

> may require information about supplies of goods and taxable supplies of services.... They may require to see documents containing such information, including any profit and loss account and balance

---

1/ Ibid., p. 66.

2/ Discussions with officials of the Office of the Revenue Commissioners, Value-Added Tax Branch, Dublin, March 10-11, 1980 and with officials of the Customs and Excise Department, London and Southend, April 8-10, 1980.

sheet relating to the business. They may take copies of the documents.... Samples of goods may also be taken. 1/

In arranging audit visits to traders, Ireland gives priority to repayment claims and cases showing a discrepancy between the information on a taxpayer's value-added tax and income tax returns. As part of the visit, purchase and sales invoices are sampled for cross-checks with other traders. About 20,000 visits are conducted annually, although many are repeat visits to the country's 70,000 taxpayers. 2/

The United Kingdom's eighty-five local value-added offices 3/ arrange about 400,000 control visits to taxpayers each year. 4/ The very large traders, 1,000 to 1,500 of them, are visited five or six times a year. The remaining taxpayers are visited on a descending scale ranging from once a year to once every five years, smaller taxpayers being visited less frequently. When conducting a visit, U.K. tax inspectors are armed with information on the taxpayer's business activities over the previous two and one-half years. They also have standard mark-ups and other performance data for the taxpayer's trade class. 5/ Assessments are raised in about one-third of the control visits and generate about £50 million annually, roughly 1 percent of total value-added tax collections. 6/

1/ Her Majesty's Customs and Excise, Value-Added Tax: General Guide, op. cit., p. 8.

2/ Office of the Revenue Commissioners, "Value-Added Tax," op. cit., p. 8.

3/ Commissioners of Her Majesty's Customs and Excise, Review of Value Added Tax, op. cit., p. 7.

4/ Ibid., p. 13.

5/ Discussion with officials of the Customs and Excise Department, London and Southend, April 8-10, 1980.

6/ Commissioners of Her Majesty's Customs and Excise, Review of Value Added Tax, op. cit., p. 13.

8. Paperwork and personnel. Although the value-added tax necessitates more detailed record keeping than the taxes it replaced, it does not appear to pose a significant accounting burden for most businesses. 1/ Medium and large sized businesses already have the information needed for a value-added tax return, both for income tax purposes and their own operational needs. Small businesses, particularly in the retail sector, are the exception to this. 2/ The special schemes available to retailers reduce the record keeping requirements, but do not eliminate the problem since they still require that purchase invoices be accurately recorded and maintained.

Because most EEC countries substituted the value-added tax for another multi-stage tax, they experienced only a moderate increase in the number of registered taxpayers. Even Ireland's combined wholesale and retail taxes, for example, were sufficiently broad based that the value-added tax only increased the number of taxpayers by about 20 percent. The United Kingdom is a notable exception to this pattern. Since the purchase tax was imposed at the wholesale level, only 70,000 taxpayers were registered. This was increased to about 1.25 million under the value-added tax. The purchase tax required a staff of about 2,000 in the Customs and Excise Department, the value-added tax about 12,000, for a net increase of 10,000. 3/

1/ Discussion with representatives of Dublin Chamber of Commerce, Dublin, March 11, 1980.

2/ Discussion with officials of Belgian accounting firm, Brussels, April 14, 1980.

3/ Commissioners of Her Majesty's Customs and Excise, Review of Value Added Tax, op. cit., p. 7.

VII. ECONOMIC EFFECTS

EEC adoption of the value-added tax was widely viewed as a move toward a more desirable system of indirect or sales taxation. The cascade turnover taxes of Belgium, Germany, Italy, Luxembourg, and the Netherlands encouraged vertical integration of business activity and unduly complicated the calculation of border tax adjustments. Ireland's retail sales tax was threatened with evasion because of abuse of the privilege to make tax free business purchases. The Green Paper characterized the U.K. tax system as "complex and discriminatory." 1/ The purchase tax applied to only a limited range of consumer durables and the selective employment tax's objective of transferring labor from services to manufacturing encountered constant administrative difficulties. EEC countries saw the value-added tax as the solution to these defects.

Unlike some of the recent U.S. proposals, the value-added taxes did not increase the relative importance of indirect taxes within the EEC. But they reduced the taxation of capital, since many of the earlier sales taxes applied to investment goods. The elimination of those taxes offset the inflationary impact of the value-added taxes, but price increases accompanied subsequent value-added tax rate increases. The calculation of precise border tax adjustments made possible by the value-added taxes simplified foreign trade by eliminating disputes over the correct export rebate or import tax. To combat the regressive character of the value-added tax, most EEC countries adopted multiple rates in search of a more acceptable distribution of the tax burden.

1. Direct-indirect tax structure. Like all developed economies, the fiscal systems of the EEC countries rely on a mixture of direct and indirect taxes. Although these terms are not precise, income taxes are normally considered direct taxes and sales, value-added, and other commodity taxes are indirect taxes. Payroll taxes are a grey area, but arguably are in the indirect category. 2/

1/ Value-Added Tax, Green Paper, op. cit., p. 3.

2/ For a discussion of these issues, see John F. Due, "Introduction: The Issues," The Role of Direct and Indirect Taxes in the Federal Revenue System, Conference Report of the National Bureau of Economic Research and the Brookings Institution, Princeton, 1964, pp. 3-23.

Adoption of the value-added tax did not change the balance between direct and indirect taxes within the EEC. One indirect tax was substituted for another, usually on a revenue-neutral basis. Indirect taxes did not become a more important source of tax revenue. This is demonstrated by Table 3 which shows taxes on goods and services as a percentage of total tax revenue for the nine EEC countries and the United States.

In no EEC country did the proportion of revenue raised through indirect taxation change materially with the adoption of the value-added tax. In the year the value-added tax was introduced, indirect taxation rose slightly in Denmark, Ireland and Italy, but fell slightly in Belgium, France, Germany, Luxembourg, the Netherlands and the United Kingdom. In every EEC country, the proportion of tax revenue raised through indirect taxation has fallen since the value-added tax was introduced. This reflects the growing importance of income taxation, not a reduction in value-added tax rates. Table 3 also shows value-added taxes as a proportion of total tax revenue in the EEC. In Denmark, Germany, Ireland and the Netherlands the value-added tax is a more important revenue source than when it was introduced; in the other countries, it has declined in importance.

Although indirect taxation has not become more important in the EEC since the adoption of the value-added tax, Table 3 does support the view that indirect taxation is more important in the EEC than in the United States. In 1977, indirect taxes generated about 25 percent of EEC country tax revenues, ranging from a low of 18 percent in Luxembourg to a high of 45 percent in Ireland. In contrast, only 15 percent of U.S. Federal, state, and local tax revenue was generated by indirect taxation, lower than any EEC country. The value-added tax accounts for much of this difference. It produced about 15 percent of EEC tax revenue, ranging from 8 percent in the United Kingdom 1/ to 21 percent in France. The U.S. counterpart, the retail sales tax, generated less than 7 percent of total U.S. tax revenue.

1/ Effective June 18, 1979, the United Kingdom increased its value-added tax rate to 15 percent. The previous rates were 8 and 12 1/2 percent. This increase, which was offset by income tax reductions, will increase the importance of the value-added tax in the country's revenue structure.

Table 3

Taxes on Goods and Services 1/ as a Percentage of Total Taxes, and Value-Added Taxes as a Percentage of Total Taxes, 1967-1977 2/ 3/

	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977
Belgium	36.7	35.4	34.9	33.7	32.6	30.2	28.8	27.7	25.1	26.6	25.9
	-	-	-	-	20.4	18.4	17.7	18.1	15.7	17.1	16.6
Denmark	38.6	41.0	42.0	36.6	34.1	34.6	33.3	29.9	32.2	33.5	35.1
	8.0 4/	18.6	20.1	18.8	18.2	18.1	17.9	17.1	17.2	17.7	19.1
France	37.1	35.6	38.2	37.0	37.0	36.8	34.9	34.3	32.0	31.6	29.7
	-	23.8	26.8	25.4	25.9	25.9	24.0	24.6	23.0	23.4	20.9
Germany	31.4	29.6	30.1	30.0	29.4	28.3	26.4	25.1	25.3	24.3	23.5
	-	13.1	16.5	17.1	17.1	16.4	14.9	14.3	14.7	14.2	13.8
Ireland	49.4	48.7	50.7	49.4	46.7	46.6	47.0	45.1	44.4	45.6	45.2
	-	-	-	-	-	-	16.3	16.2	14.7	15.6	17.0
Italy	37.0	35.9	36.5	35.9	34.1	32.0	32.5	31.6	27.9	26.8	27.0
	-	-	-	-	-	-	15.1	16.8	13.7	13.8	14.5
Luxembourg	23.2	22.5	20.8	19.4	20.1	21.7	20.9	17.7	20.1	19.2	17.8
	-	-	-	6.7	11.1	12.1	11.7	10.5	11.8	11.1	10.3
Netherlands	26.2	26.7	24.4	26.1	25.4	25.3	24.0	22.2	22.3	23.2	24.0
	-	-	11.2	14.6	15.5	15.8	15.2	14.3	14.4	15.0	15.9
United Kingdom	26.9	27.0	27.5	26.2	26.2	26.0	25.7	25.1	23.3	23.8	24.0
	-	-	-	-	-	-	3.7 4/	8.8	8.7	8.6	8.3
United States	16.8	17.3	16.4	16.9	18.1	17.2	16.9	16.3	16.1	16.1	15.0
	4.7	5.1	5.2	5.6	6.1	6.2	6.3	6.5	6.7	6.8	6.5

1/ Includes general sales, value-added, and specific excise taxes.

2/ Tax revenues include all levels of government Federal, state, and local.

3/ First line is taxes on all goods and services, second line is value-added tax only. For United States, second line is state retail sales taxes.

4/ Value-added tax in effect for only part of the year.

Source: Organization for Economic Cooperation and Development, Revenue Statistics of OECD Member Countries, 1965-1978, Paris, 1979.

2. Capital goods. The cascade turnover taxes of Belgium, Germany, Italy, and the Netherlands applied to capital, as well as consumption, goods. France's production tax, the forerunner of the value-added tax "placed a heavy tax penalty...on the purchase of new capital goods." 1/ In its study of the value-added tax for the United Kingdom, the NEDO report cautioned that one danger of extending the scope of the purchase tax was that "a part of indirect taxes could fall on net capital formation, to the extent that producers of plant and equipment buy goods from unregistered businesses." 2/

Unlike most of the taxes it replaced, the value-added tax does not burden capital goods. Taxable persons are entitled to a deduction for tax imposed on the purchase of capital goods. The deduction does not subsidize the purchase of capital goods, it simply eliminates the tax that has been imposed on them. Although several EEC countries restricted the capital goods deduction on a transitional basis, Belgium still denies the deductibility of 5 percentage points of its 16 percent value-added tax paid on capital equipment. Although this is done primarily for revenue reasons, it means that capital goods bear a 5 percent value-added tax in Belgium.

3. Price level. Two cases must be distinguished in assessing the impact of the value-added tax on the general price level: (1) as an additional tax and (2) as a substitute revenue source. As a new (or increased) tax a value-added tax is likely to increase prices, provided there is an accommodating monetary policy. The alternative of stable prices assumes a restrictive monetary stance with its consequences of reduced output and employment. As a substitute tax, the inflationary impact of the value-added tax may be offset by the elimination of the tax it replaces. In the short run, sales taxes tend to be reflected in higher output prices and income taxes in lower factor returns. Thus, substituting a value-added tax for another sales tax may leave the price level unchanged, but substituting it for an income tax may be inflationary. The price changes associated with a value-added tax may also be affected by the general economic conditions at the time the tax is introduced or increased.

1/ Due, op. cit., p. 122.

2/ National Economic Development Office, op. cit., p. 64.

European experience seems to support these views. When the value-added tax replaced another sales tax it had only a minimal impact on the price level, but when it was increased or when it replaced an income tax it was inflationary. Germany's changeover to the value-added tax did not have any perceptible impact on the general level of consumer prices, perhaps because the tax was introduced during a recession. 1/ Some goods, such as canned foods and textiles became cheaper and some services, such as haircuts and restaurant meals, with a high proportion of value added became more expensive as the 11 percent value-added tax replaced the 4 percent cascade tax. 2/

Consumer prices in the Netherlands rose 5 percent in the first three months 3/ following the introduction of the value-added tax and 6.5 percent for the year. 4/ Most of this increase, however, was attributable to the general "inflationary economic situation" in the economy. 5/ The value-added tax alone increased consumer prices by about 1.5 percent. 6/ Belgium postponed its introduction of the value-added tax from 1970 to 1971 because of inflationary fears. Consumer prices still rose 5.6 percent in 1971, but this was in line with the experience of other major European countries which did not introduce a value-added tax that year. 7/ Swedish prices did not increase in response to the

---

1/ Eric Schiff, Value-Added Taxation in Europe, American Enterprise Institute, 1973, p. 26.

2/ National Economic Development Office, op. cit., p. 40.

3/ Ibid., p. 40.

4/ Schiff, op. cit., p. 29.

5/ Millenaar, op. cit., p. 12.

6/ National Economic Development Office, loc. cit.

7/ Schiff, op. cit., p. 31.

introduction of the value-added tax. 1/ In the United Kingdom, the retail price index rose 1.9 percent in the month the value-added tax was introduced, "but by no means all of that increase was due to VAT." 2/

In contrast to this pattern of relatively stable prices associated with the introduction of the value-added taxes, prices clearly rose when the taxes were increased. The July 1, 1968 increases, for example, in Germany's dual-rate value-added tax from 10 percent to 11 percent and from 5 percent to 5 1/2 percent "are estimated to have raised the prices of goods for private consumption by 0.8 percent on the average." 3/ Belgian prices increased by about 0.6 percent in response to the 1971 increase in the value-added tax from 12 percent to 14 percent. 4/

The analysis of price effects in Sweden and Denmark is improved by the existence of a special price index. Both countries maintain two consumer price indices; one is a comprehensive index, the other a net index which eliminates the influence of value-added and other indirect taxes. A comparison of the movements in the two indices following a value-added tax increase should provide information on the price impact of the tax increase relative to the effect of more general economic conditions. When Sweden increased its standard rate value-added tax from 10 percent to 15 percent on January 1, 1971, the comprehensive, tax-exclusive, price index rose by about 3.3 percent in January alone while the net index declined. 5/

Denmark's initial imposition of its 10 percent value-added tax was akin to a tax increase because the coverage of the new tax was much wider than that of the wholesale tax it replaced. A comparison of the two indices reveals that the tax-exclusive index rose 6.2 percent in the month the tax

---

1/ Ibid., p. 32. Sweden, of course, is not a member of the EEC, but has had a value-added tax since 1969.

2/ Johnstone, op. cit., p. 122.

3/ Schiff, op. cit., p. 27.

4/ Ibid., p. 30.

5/ Ibid., p. 34.

was introduced while the net index increased only 1.1 percent. 1/ Goods not previously covered by the wholesale sales tax, such as food and tobacco, rose in price by a full 10 percent in the month the 10 percent tax was introduced. 2/ Subsequent 2.5 percent increases in the value-added tax, from 10 percent to 12.5 percent and from 12.5 percent to 15 percent, were associated with roughly 2.0 percent increases in the tax-exclusive index relative to the net index. 3/

The recent experience in the United Kingdom also confirms the inflationary impact of value-added tax increases. The Conservative government's first budget, introduced June 12, 1979, announced a major increase in the value-added tax and reductions in the income tax. The previous 8 percent and 12.5 percent value-added tax rates on covered items were increased to a single 15 percent rate. Zero-rated items, such as food and housing, were not affected. Income taxes were reduced by raising allowances and thresholds, reducing rates, and widening tax brackets. 4/ The Treasury predicted that the higher value-added tax rate would increase retail prices about 3.5 percent. 5/

The value-added tax increase was effective June 18, 1979. 6/ In July alone, the retail price index increased by 4.3 percent. "Three quarters of July's record jump was due to the budget measures, especially higher VAT." 7/ Because of the extensive use of zero rates in the United Kingdom, the value-added tax applies to only about 50 percent of

---

1/ Ibid., p. 40.

2/ Ibid., p. 42.

3/ Ibid., p. 40.

4/ Her Majesty's Treasury, "The Budget," Economic Progress Report Supplement, June 1979, p. 1.

5/ Ibid., p. 1.

6/ International Bureau of Fiscal Documentation, op. cit., United Kingdom, section 6.3.3.

7/ "Business Britain," The Economist, August 25, 1979, p. 52.

consumer expenditure. 1/ Thus, the July 1979 increase in the price level was very close to what would be expected from a 7 percentage point increase in a value-added tax that applied to one-half of consumption.

4. Foreign trade. The value-added taxes did not have any dramatic balance of trade effects. Like any other sales tax, the value-added tax can be rebated on exports and levied on imports. This is the familiar destination principle of border tax adjustment allowed by the General Agreement on Tariffs and Trade (GATT). With the exception of the United Kingdom and its selective employment tax, the EEC countries did not increase the proportion of their taxes eligible for the destination principle by adopting the value-added tax. The cascade turnover taxes of Belgium, Germany, Italy, Luxembourg and the Netherlands, Denmark's wholesale sales tax, Ireland's wholesale and retail taxes, and the United Kingdom's purchase tax all qualified for the destination principle.

But the calculation of exact border tax adjustments was virtually impossible under the cascade turnover taxes. The average adjustments sanctioned by the Treaty of Rome over-compensated in some cases and undercompensated in others.

> It also appears that in Italy it is really true that rebates given to exporters over-compensated for the cascade taxes imposed at earlier stages. There was a real, rather than just an apparent, element of export subsidy in the Italian system. With the introduction of VAT this would disappear and hence exporters have been unenthusiastic about the change. 2/

At a minimum, the value-added tax encouraged trade by eliminating disputes over the correct border tax adjustment. At any stage in the production and distribution process, the use of invoices provides a clear measure of the tax borne by a product.

Although the purchase tax did not share the defects of the cascade tax, the NEDO report conceded that a value-added tax would be marginally better than the U.K. purchase tax in eliminating the tax on exports.

1/ Her Majesty's Treasury, op. cit., p. 2.

2/ John Chown, VAT Explained, Kogen Page (Associates) Ltd., London, 1972, p. 137.

> VAT does not arise on export sales, although any tax paid on goods or services entering into exports can be credited to the exporter in the usual way. At present there is some overspill of indirect taxes into exports: a small amount of purchase tax, e.g., on office stationery and company cars, fall incidentally on industrial costs.... If these taxes were replaced by a VAT which could be rebated this overspill would be avoided; if all else remained unchanged, costs would be lowered by that amount and exports would thus be made more competitive. 1/

5. Distribution of tax burden. A comprehensive value-added tax is regressive since lower income taxpayers consume a higher proportion of their income than do middle and upper income taxpayers. 2/ With the exception of Denmark, the EEC countries moderate the regressive nature of the value-added tax with multiple rates. The standard rate is supplemented by a higher rate on luxuries such as automobiles and television sets or by a reduced rate on food, clothing, and other necesssities. The Netherlands, for example, taxes food, public transportation, and medicine at 4 percent, but other consumption at 18 percent.

> The lower rate applies to primary necessities which were favored before VAT. Primary necessities are considered to include goods and services which occupy a more important place in the expenditure pattern of lower income groups than in that of other people. This list of lower rates makes the VAT system in a certain sense progressive and gives it a social function. 3/

To characterize the value-added tax as "in a sense progressive" may be an overstatement. Most EEC tax experts believe that, at most, the structure of multiple rates makes the value-added tax proportional with respect to income.

1/ National Economic Development Office, op. cit., p. 2.

2/ Joseph A. Pechman, "Statement on the Value-Added Tax," in Tax Restructuring Act of 1979, Hearings before the House Committee on Ways and Means on H.R. 5665, November 8, 14, and 15, 1979, pp. 89-91.

3/ Millenaar, op. cit., p. 5.

VIII. LESSONS AND ANALYSIS FOR THE UNITED STATES

EEC experience is rich with lessons regarding U.S. adoption of a value-added tax. The EEC welcomed the tax as a long-overdue reform of an unwieldy and discriminatory system of indirect taxation. This contrasts sharply with recent suggestions in the United States that a value-added tax be used to reduce the income and social security taxes. 1/ Months, perhaps years, must be devoted to planning and publicizing the tax before its introduction. Difficult decisions must be made regarding coverage, collection and control procedures. A single-rate tax is administratively attractive, but may be politically unacceptable. If the Federal tax structure is to rely more heavily on consumption taxation, serious consideration should be given to a retail sales tax in lieu of a value-added tax. It would allow the United States to benefit from its experience at the state level and would have the same economic impact as a value-added tax.

1. Motivation for adoption. The defects of the cascade turnover taxes were the driving force behind EEC adoption of the value-added tax. The multiple taxation of products, relatively favorable taxation of concentrated enterprises, and uncertain border tax adjustments combined to create an intolerable situation in a common market. Tax barriers, reasoned the drafters of the Treaty of Rome, could be as effective as tariffs and quotas in impeding the free flow of goods and services. The value-added tax was the logical alternative to the turnover taxes levied by five of the original six EEC countries. The sixth, France, already had a value-added tax. It enabled the Member States to substitute one indirect tax for another and thus leave the balance between direct and indirect taxes undisturbed. It drew on decades of European experience with multi-stage taxation, but avoided the problems learned from that experience.

The United States has no cascade taxes on which the case for a value-added tax can be based. It rests instead on whether the United States should replace some of its income taxes with a consumption tax. As shown by Table 3 (above), taxes on goods and services are about 15 percent of total

---

1/ See, for example, Tax Restructuring Act of 1979, op. cit., pp. 1-6.

U.S. tax revenues. In contrast, consumption taxes generate about 25 percent of EEC country tax revenues. The value-added tax accounts for much of this difference.

2. Planning and publicity. Although each of the original EEC Member States was thoroughly familiar with multi-stage sales taxes, the value-added taxes were not implemented overnight. They required extensive education and information programs, conducted through seminars, newspapers, television, and radio. Taxpayers needed to be told how the new systems would operate and consumers were interested in how prices would be affected.

Germany's cascade tax was perhaps the most comprehensive in the EEC, applying even to services and retail sales. Few taxpayers are subject to the value-added tax who were not also familiar with the turnover tax. But even this extensive knowledge of sales taxation did not relieve the German government of the need to conduct a 12-month information program before the tax became effective.

For the United States, the U.K. experience may be more relevant. The substitution of the value-added tax for the single-stage purchase tax increased the number of taxpayers from 75,000 to 1.25 million. The U.K. Customs and Excise Department responsed to this challenge by planning, drafting, and publicizing the tax from autumn 1970 until its April 1, 1973 effective date, a period of two and one-half years. The United States also would be faced with a large increase in the number of taxpayers because the value-added tax would be a net addition to the Federal tax structure. Accordingly, it may need an education and information program similar in duration and intensity to the United Kingdom's.

3. Technical issues. Any U.S. value-added tax would presumably conform to the EEC model and be a consumption tax applying to all stages of production and distribution. But the design of the tax would require a large number of decision on specific issues. Terms like "taxable transactions" and "taxable persons" must be defined with the precision necessary for tax purposes. Even if the objective is a broad-based consumption tax, demands for exemptions and preferential rates are inevitable. Transactions failing to reflect a market price are not amenable to a straight forward application of the value-added tax. Tuition charges of publicly-supported universities and fees for checking account deposits are just two examples. Consideration must be given to the need for special schemes for small enterprises and farmers and eligibility requirements must be

reviewed. The tax return mirrors the structure of the tax itself. A complex tax cannot be reported on a simple return. The United Kingdom was able to reduce its return (see Chart 2, above) to a single page only after reducing the exemptions "and a rigorous scrutiny by the Department of the need for other information." 1/ Moreover, the U.K. return provides only one cell for reporting output tax, although sales may have been taxed at more than one rate. The output tax on the return is thus a summary figure based on a taxpayer's identification of the differentially taxed items.

The taxable period must be decided. Monthly returns, as in many of the EEC countries, provide prompt revenue collection but increase the paperwork. The U.K.'s quarterly returns are popular with taxpayers because of the cash flow advantage. The value-added tax requires an active enforcement effort, particularly at the retail level. Combining administration and enforcement with the income tax may reduce costs, but the U.K. experience demonstrates there is considerable merit in separate departments to oversee taxes that are decidedly different.

4. Rates and exemptions. Without exception, European tax experts stress the administrative superiority of a single rate tax. Multiple rates and exemptions reduce the regressivity of the tax, but complicate its design and administration. Great care must be taken to clearly define the specially-taxed items. Clerks and consumers may still question why bread is tax free and biscuits are not, or why yogurt is taxed only if it is frozen. Reduced rates diminish the revenue base of the tax, but not the responsibilities of the tax authorities since eligibility for the different rates must be verified. The United Kingdom has calculated that if food, children's clothing, and other zero rated items were taxed at the standard rate and if existing standards of control and enforcement were applied, "administrative costs would increase by about 8 percent but the increase in net revenue would be over 50 percent." 2/

1/ Commissioners of Her Majesty's Customs and Excise, Review of Value Added Tax, op. cit., p. 10.

2/ Ibid., p. 8.

The EEC exemptions for financial and insurance services seem alien to a value-added tax. Taxes paid on purchases have to be divided between exempt and taxable activities to determine the deductible proportion. Unlike food, financial and insurance services are not considered necessities meriting a reduced rate of taxation. In transactions between taxable persons, exemption creates the multiple taxation characteristic of the discredited turnover taxes. One alternative is to charge value-added tax on the interest cost of business and consumer loans. Taxable persons could deduct the tax, but consumers borrowing to finance a higher level of consumption could not. In the insurance area, value-added tax could be imposed on the "loading" charges, premiums less claims.

5. Retail sales tax alternative. The value-added tax debate in the United States should include consideration of a retail sales tax as an alternative. Both tax final consumption. The EEC multi-stage sales tax experience which led to the value-added tax is matched in the United States by experience at the state level with the retail sales tax. Advocates of a value-added tax contend it is a more secure revenue source because it does not concentrate collection at one stage and that it successfully avoids the taxation of business purchases without the use of exemption certificates. Those favoring a retail sales tax question these arguments and stress that a retail sales tax would involve fewer taxpayers.

(a) Revenue collection and control of fraud. A value-added tax generates revenue at each stage in the production and distribution process, a retail sales tax at only the final stage. But the piecemeal collection of value-added tax revenue may be interrupted by the deduction mechanism. A retailer, for example, may deduct tax invoiced on purchases, even if the purchased items have not been sold. Thus, the deduction may enable the retailer to obtain a refund of all previous value-added tax collected on the purchases. Accordingly, the entire value-added tax will be recollected on the retail sale, similar to a retail sales tax.

A value-added tax is not necessarily superior to a retail sales tax in controlling fraud at the retail level. Either tax can be avoided by a retailer suppressing his sales volume. This might be done directly or by making cash withdrawals from business receipts for personal use. The fraudulent retailer either receives a refund of value-added tax invoiced on purchases or avoids paying retail sales tax. In either case, the revenue consequences are identical. If sales are artificially reduced by $1,000, the deduction for

value-added tax imposed on purchases eliminates all tax that would have been charged on the sale. It is like the suppressed sales have been taxed at a zero rate. Similarly, a retailer subject to a retail sales tax will be able to avoid the tax on the full $1,000 in suppressed sales.

The key to detecting this method of evasion lies in the tax authorities' awareness of reasonable retail margins. The value-added tax return does provide a direct record of sales and purchases to which a hypothetical margin can be applied. Purchases, in contrast, are not normally reported on a retail sales tax return, but can be reviewed in an audit.

(b) Enforcement. A taxable person must have a purchase invoice to deduct value-added tax. "A businessman would be anxious to ensure that his predecessor in the chain of production and distribution showed on his invoice the exact amount of tax paid, so that he could in turn deduct it from the tax liability on his sales." 1/ Whether the invoices vest a value-added tax with superior enforcement attributes is debatable.

As Dorothy Johnstone has observed, an invoice provides "only discouragement and not complete prevention" 2/ against a taxpayer falsifying his activities to the revenue authorities. Cross checking of value-added tax sales and purchase invoices is possible, but only for transactions between taxable persons. By definition, these are non-retail transactions that would be exempt from retail sales tax. No cross checking is possible at the retail level where sales are made to final consumers who cannot deduct the tax. At this level, the value-added tax must be enforced like the retail sales tax.

(c) Business purchases. Ideally, both a value-added tax and a retail sales tax are confined to final consumption; neither taxes items purchased for business use. Only the mechanism for attaining this result differs. A taxable person is allowed to deduct any value-added tax imposed on

---

1/ Royal Commission on Taxation, Sales Taxes and General Tax Administration, Vol. 5, Ottawa, 1966, p. 47.

2/ Johnstone, op. cit., p. 66.

items purchased for business use. In contrast, under a retail sales tax, the buyer certifies to the seller that he is making a tax free purchase for business use.

Incorrect treatment of business purchases creates two types of problems. Taxing business purchases creates the multiple taxation characteristic of a cascade tax. Exempting "business purchases" that really represent final consumption erodes the tax base.

Either tax can avoid the cascade tax problem. "The problem of the sales tax burden on capital goods is not insoluble within the framework of a retail sales tax." 1/ Capital goods and other business purchases should be exempt from retail sales tax and the value-added tax should allow tax imposed on these purchases to be deducted.

> It is possible to conceive of a retail sales tax which is imposed only on goods and services purchased by ultimate consumers. The tax would be suspended on all sales of goods and services delivered for business use. It is then equivalent to the deduction variant of the consumption type of value-added tax which taxes gross receipts from sales of goods and services and deducts a firm's outlays on goods and services used in business. 2/

The value-added tax may have a slight advantage in protecting against erosion of the tax base since it may be easier to control the taxpayer claiming the deduction than the seller making an exempt sale. In part, Sweden replaced its retail sales tax with a value-added tax because "audit of business purchasers' claims for tax credits was thought to be simpler and more effective than verification of vendors' records as to why no retail tax had been collected on a particular sale." 3/

1/ Martin Norr and Nils G. Hornhammar, "The Value-Added Tax in Sweden," Columbia Law Review, Vol. 70, No. 3, March 1970, pp. 392-393.

2/ Clara K. Sullivan, The Tax on Value Added, Columbia University Press, New York, 1965, pp. 252-253.

3/ Norr and Hornhammar, op. cit., p. 395.

But Clara Sullivan, in her study of the value-added tax, questions this.

> The failure in retail sales taxation to suspend the tax on all sales to business firms is attributable in part to probable avoidance or evasion; and there is no reason to believe that the deduction of all purchases for business use under the value-added tax would improve the situation.... In the last analysis...improved control under the deductive value-added technique as compared with the suspensive system depends on whether it is easier to trace the disposition of purchases by a vendor rather than a vendee; and there seems to be no reason why this should be the case. What difference does it make whether a firm as a vendee obtains certain purchases in suspension of tax or receives the same purchases burdened with tax and is then allowed to reduce its tax liability by the taxes paid on such purchases? 1/

(d) Number of taxpayers. The conventional wisdom suggests that a retail sales tax would involve far fewer taxpayers than a value-added tax. This overlooks the fact, however, that a retail sales tax applies to retail sales, not just retailers. Wholesalers, processors, and even manufacturers make limited retail sales. A recent U.K. study comparing a retail sales tax with the value-added tax discovered that "more than 900,000 of the 1.25 million traders who are registered for VAT supply at least some consumers on a regular basis." 2/ Based on this result, a retail sales tax would involve only about 25 percent fewer taxpayers than a value-added tax.

6. Economic effects. Advocates of a U.S. value-added tax, or a retail sales tax, contend that it would improve capital formation and the trade balance while raising large amounts of revenue to finance income and social security tax reductions. Critics respond that it would be inflationary, regressive, and a Federal invasion of a traditionally state

---

1/ Sullivan, op. cit., pp. 251, 253.

2/ Consultative Committee of Accountancy Bodies, Elimination of VAT on Transactions between Registered Traders, Report by a Working Party, 1979, p. 2.

and local revenue source. This section appraises the value-added tax in light of these conflicting views as a substitute for either the corporate income tax or the employer portion of the social security tax.

(a) Capital formation. A tax on capital income, such as the corporate income tax or the individual income tax on interest and dividends, reduces the after-tax return to capital. Consequently, it may encourage present consumption relative to saving for future consumption.

To illustrate this point, consider an economy without taxes. An individual with $100 of income could purchase $100 of consumption goods this year or could save the income and purchase $110 of consumption goods next year, assuming the interest rate is 10 percent. Thus, an can consume $110 in the future by not consuming (saving) now. If a 50 percent income tax is introduced, the individual, after paying the tax, can purchase $50 of consumption goods this year or can save the $50 and have $52.50, after tax, next year, a 5 percent rather than 10 percent rate of return. The 50 percent income tax cuts the return to saving in half. Given this bias against future consumption, the individual may save less.

In contrast, a value-added tax, like the social security tax, is neutral between present and future consumption because it does not apply to the return on saving. With a value-added tax, an individual has the choice of consuming $50 this year and paying $50 in tax or saving the $100 in income and consuming $55 next year and paying $55 in tax. The rate of return on saving is unaffected by the value-added tax; it is still 10 percent.

Thus, substituting a value-added tax for the corporate income tax should increase savings, provided individuals respond to the higher after-tax rate of return by saving more. At a given level of real income, an increase in savings will be reflected in improved capital formation, provided the interest rate falls and producers respond to the lower cost of capital by using more capital intensive methods of production. Substituting a value-added tax for the social security tax, however, will not increase savings since the after-tax return on savings will be unaffected.

(b) Inflation. While the impact of taxes on prices is a controversial issue, substituting a value-added tax for the corporate income tax is likely to be inflationary. In the

short run, the corporate income tax is probably reflected in a reduced after-tax rate of return to capital rather than in higher product prices. Consequently, prices may not fall in response to a corporate rate cut and there will be no offset to the inflationary impact of the value-added tax. This will be primarily a "one-shot," rather than a recurrent annual, increase in the price level, but it may be intensified as wage contracts, social security payments, and other indexed items are adjusted.

Substituting a value-added tax for the social security tax is probably less inflationary. Reducing the social security tax (at least the employer portion) would reduce business' labor costs and therefore prices. Whether this would fully offset the inflationary impact of the value-added tax is debatable. To the extent the social security tax cut was not fully reflected in reduced prices, there would be a net increase in the price level.

(c) Balance of trade. Although a value-added tax, but not the corporate income tax, can be levied on imports and rebated on exports, it is doubtful whether the U.S. trade balance would significantly improve from substituting a value-added tax for the corporate income tax. A modest trade balance improvement might result from replacing the social security with a value-added tax.

This is because the inflationary and trade impacts of the value-added tax are closely related; higher prices will offset any expected trade balance improvement. It seems likely that the immediate impact of substituting a value-added tax of 5 percent for the corporate income tax would be to increase prices by about 5 percent. Since the tax would be rebated on exports, exports would leave the country tax free. While domestic prices would be 5 percent higher, export prices would remain unchanged. Foreign consumers, therefore, would find U.S. products no more attractive than before and there would be no increase in demand for U.S. exports.

Since imports would be subject to the value-added tax, their prices also would increase by 5 percent, the same as for domestic products. Domestic consumers would find imports just as attractive as before; there would be no incentive to reduce the demand for imports. Thus, on both the export and import side, there would be no immediate impact on the U.S. trade balance from substituting a value-added tax for the corporate income tax.

Substituting a value-added tax for the social security tax, however, would improve the trade balance, provided the price level increased by less than the value-added tax. Because of the price-dampening effect of reducing the social security tax, this is a clear possibility.

Other countries, however, might attempt to offset any U.S. trade advantage that did develop. The major trading partners of the United States have corporate income and social security taxes as well as value-added taxes. According to Table 4, which compares taxes as a percent of gross domestic product, the United States has a relatively high corporate income tax and relatively low social security taxes. Consequently, the U.S. trade partners could moderate or offset any trade impact by substituting higher value-added taxes for their corporate income and social security taxes.

(d) Distribution of tax burden. A comprehensive value-added tax is regressive since lower income taxpayers consume a higher proportion of their income than do middle and upper income taxpayers. Therefore, substituting a value-added tax for the corporate income tax, which is mildly progressive 1/ because it falls on income from capital, would add a regressive element to the tax structure. The social security tax also is regressive 2/ because it is limited to the first $25,900 3/ of wages and does not apply to income from non-labor sources. Accordingly, substituting a value-added tax for the social security tax would probably not affect the distribution of the overall tax burden. One regressive tax would be substituted for another.

The regressivity of a particular tax, such as the value-added tax, is not a fatal flaw.

> People concerned with the relative treatment of rich and poor should focus on the total impact of government policy on the distribution of real income. The regressivity of a tax is merely one component of the picture. If VAT is efficient as a

---

1/ Richard A. Musgrave and Peggy B. Musgrave, Public Finance in Theory and Practice, Second Edition, McGraw-Hill, 1973, p. 389.

2/ Ibid., p. 389.

3/ Commerce Clearing House, U.S. Master Tax Guide, 1980, p. 30.

Table 4

Federal, State and Local Tax Revenues for Selected Countries as Percent of Gross Domestic Product, by Type of Tax, 1977
(Country Rankings in Parentheses)

Country	Total	Indirect Taxes	Direct Taxes							
			Social Security 2/							
		Sales and Excises 1/	Total	Employer	Employee and Self Employed	Corporate Income	Noncorporate Income 3/	Property 4/	Other 5/	Total Direct Taxes 6/
Belgium	42.89(4)	11.11(5)	13.27(6)	8.55(4)	4.72(6)	2.65(6)	14.25(3)	1.19(12)	0.42(12)	31.78(4)
Canada	31.98(10)	8.31(10)	3.51(12)	n.a.	n.a.	3.69(2)	10.59(9)	3.13(3)	2.75(2)	23.67(11)
Denmark	41.95(5)	14.73(1)	0.52(13)	0.24(12)	0.28(12)	1.30(13)	21.87(2)	2.43(5)	1.10(6)	27.22(8)
France	39.57(6)	11.74(3)	16.58(2)	11.72(3)	4.86(5)	2.21(9)	5.22(12)	1.36(10)	2.46(3)	27.83(6)
Germany	38.17(7)	8.96(7)	12.95(7)	6.96(7)	5.99(4)	2.09(11)	11.86(7)	1.23(11)	1.08(7)	29.21(5)
Italy	37.55(8)	10.12(6)	16.40(3)	13.12(1)	3.28(8)	2.38(8)	7.04(11)	1.37(9)	0.24(13)	27.43(7)
Japan	22.22(13)	3.34(13)	6.84(11)	3.54(10)	3.30(7)	3.56(3)	4.90(13)	1.96(7)	1.62(4)	18.88(12)
Luxembourg	49.97(2)	8.89(8)	15.19(4)	8.37(5)	6.82(2)	9.34(1)	13.18(4)	2.64(4)	0.73(9)	41.08(2)
Netherlands	46.32(3)	11.13(4)	17.20(1)	7.88(6)	9.32(1)	3.13(5)	12.21(6)	1.80(8)	0.85(8)	35.19(3)
Sweden	53.38(1)	11.95(2)	13.54(5)	12.92(2)	0.62(11)	1.51(12)	22.16(1)	0.48(13)	3.74(1)	41.43(1)
Switzerland	31.51(11)	5.78(11)	9.28(8)	3.25(11)	6.03(3)	2.17(10)	11.62(8)	2.18(6)	0.48(11)	25.73(10)
United Kingdom	36.60(9)	8.77(9)	7.06(10)	4.00(9)	3.06(10)	2.51(7)	12.49(5)	4.42(1)	1.35(5)	27.83(6)
United States	30.30(12)	4.54(12)	7.52(9)	4.43(8)	3.09(9)	3.50(4)	10.14(10)	3.98(2)	0.62(10)	25.76(9)

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ Includes general sales, value-added, and specific excise taxes.

2/ Includes contributions of employers, employees, and self employed. Category is broadly defined to include all tax payments to institutions of general government providing social welfare benefits, provided they are levied as a function of pay or a fixed amount per person. Thus, for the United States this category includes contributions to the railroad retirement fund, unemployment insurance fund, workman's compensation fund, and civil service retirement program in addition, of course, to the more familiar social security-type payments made pursuant to the Federal Insurance Contributions Act (FICA).

3/ Includes income taxes on individual and unincorporated enterprise, such as proprietorships and partnerships.

4/ Includes taxes on net wealth, immovable property, estates, and gifts.

5/ Includes taxes on employers based on payroll or manpower and miscellaneous taxes which cannot be classified within a specific direct tax category.

6/ Computed by subtracting sales and excises from total.

Source: Revenue Statistics of OECD Member Countries, 1965-1978.

> way to increase the price of consumption, then the regressivity of VAT can be readily offset in the total income distribution policy. 1/

This point has also been grasped by a series of Swedish Royal Commissions (expert committees) appointed by the Social Democratic government to explore the increased use of indirect taxation.

> That sales taxes take a higher proportion of lower incomes than of higher is clear, the expert committees agreed. But this 'social' reason is no longer enough to warrant rejection of indirect taxes as a supplement to direct. The burden of indirect taxes on lower-income recipients can be made up in part by adjustments in the income tax, and in still larger part through the social security and welfare systems.... To the Swedes, the problem of the lower-income groups is more a problem of social and welfare policy than of tax policy. 2/

In addition to accommodating the value-added tax through adjustments in the overall income distribution policy, the regressivity of a value-added tax could be moderated by either exemptions and multiple rates or by a refundable credit. Although the multiple rate method is popular in Europe, it requires that the differentially-taxed items be defined by the tax administrators. A refundable income tax credit for value-added tax paid on a specified minimum amount of consumption avoids the definitional problems, but care must be taken to insure that the credit reaches individuals who may not appear on an income tax return. The credit is presently used by six of the forty-five states that impose retail sales taxes. 3/

1/ Gerard M. Brannon, "Is the Regressivity of the Value-Added Tax an Important Issue?," Tax Notes, December 31, 1979, p. 881.

2/ Norr and Hornhammer, op. cit., p. 386-387.

3/ Colorado, Hawaii, Idaho, Massachusetts, Nebraska, and Vermont. See Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1976-77 edition, Vol. 2, p. 172.

(e) Revenue potential. Total personal consumption expenditures will be about $1,628 billion in 1980. 1/ This includes the imputed rental value of owner-occupied housing, the imputed value of services of financial intermediaries, foreign travel expenditures, and religious and welfare activities. Excluding these items would reduce the tax base to about $1,400 billion, 2/ but taxing sales of new housing, as in the EEC, would increase it to about $1,500 billion. 3/

A credit or refund for tax paid on a basic level of expenditure, say $2,000 per person, would generate an aggregate refund of $4.4 billion for each 1.0 percent of value-added tax. 4/ The cost would be lower if the credit was phased out as income increased. If the value-added tax could be applied to the broad base of $1,500 billion, the net revenue of the tax, after allowing for the refund or credit, would be about $10.5 billion for each percentage point. This is equivalent to 14.5 percent of estimated 1980 corporate tax receipts of 7.5 percent of estimated social security tax collections. 5/

7. Federal-state relations. Forty-five states and the District of Columbia impose general sales or use taxes, 6/ a revenue source which they tend to view as belonging

---

1/ Bureau of Economic Analysis, Economic Indicators, August 1980, p. 1.

2/ Based on data in Bureau of Economic Analysis, Survey of Current Business, July 1979, p. 37.

3/ Ibid., p. 48.

4/ This assumes a 1980 population of 220 million. See Bureau of the Census, Statistical Abstract of the United States, 1979, p. 6.

5/ Executive Office of the President, Office of Management and Budget, The United States Budget in Brief, 1981, Washington, D.C., 1980, p. 70.

6/ Commerce Clearing House, State Tax Guide, All States, Loose Leaf Service.

exclusively to them. These taxes account for about 35 percent of state and local government tax revenue. 1/ In contrast, excise taxes generate only 4.2 percent of total Federal tax collections. 2/ As shown by Table 4, taxes on goods and services are lower in the United States than in most other developed countries.

A Federal value-added tax might make it more difficult for states and localities to increase their sales taxes. The 1972 National Governors Conference, for example, adopted a resolution that "the value-added tax would directly compete with state sales taxes in 45 states...." 3/ But it probably would not prevent such increases. Although there is a limit to how high any tax can be increased, it is unlikely that total U.S. sales taxes are approaching it. Comparison with foreign tax levels indicates that U.S. sales taxes could be somewhat higher.

No single level of government has exclusive rights to a particular tax. The Federal government and most states tax individual and corporate income. Some localities also levy income taxes. Both states and localities have retail sales taxes. Selective sales taxes are used by all three levels of government. The issue is not the number of jurisdictions levying a tax, but its overall level.

Administratively, a Federal value-added tax would not unduly complicate the operation of state retail sales taxes. Assuming the invoice or credit method was adopted, Federal value-added tax liability would be equal to tax on sales less tax on purchases. No adjustment would be necessary for interstate sales; in effect, they would be taxed on an origin basis.

1/ Bureau of the Census, Statistical Abstract of the United States, 1979, p. 287.

2/ Executive Office of the President, Office of Management and Budget, op. cit., p. 70. This percentage is for 1979 and thus excludes windfall profit tax revenues.

3/ Advisory Commission on Intergovernmental Relations, The Value-Added Tax and Alternative Sources of Federal Revenue, Washington, 1973, p. 11.

Because of likely differences in the tax bases, it is doubtful that a Federal value-added tax could be coordinated with the state sales taxes. Each level of goverment would administer its tax. Separate taxes, admittedly, would mean higher administrative and compliance costs. Each level of government would require a collection and audit capability. Taxpayers would have to become familiar with separate tax bases and separate returns. Revenue departments and taxpayers, however, already face this problem with Federal and state income taxes. Efforts to provide Federal-state cooperation and coordination have not been successful. Although states may have their individual income taxes collected by the Federal government, none have taken advantage of this "piggyback" authority. Separate administration may not be a desirable situation, but neither is it a good argument for rejecting a particular tax.

Department of the Treasury
Washington, D.C. 20220

Official Business
Penalty for Private Use, $300

U.S. TREASURY LIBRARY
10110007

Posta
Department of the Treasury

TREAS-551

U.S.MAIL